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Tax Section

Report on Notice 2016-52

On Splitter Arrangements from Foreign-Initiated Tax Adjustments

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On Splitter Arrangements from Foreign-Initiated Tax Adjustments

This report[1] addresses Notice 2016-52 (the "**Notice**"), issued on September 15, 2016.[2] The Notice announced that the Department of the Treasury (the "**Treasury**") and the Internal Revenue Service (the "**IRS**") intend to issue regulations that would define two new foreign tax credit splitter arrangements, applicable to section 902 corporations under section 909,[3] resulting from foreign-initiated adjustments to the foreign income tax liability of a section 902 corporation. The Notice suggests that the Treasury and the IRS were prompted to identify the new splitter arrangements by the prospect of large foreign-initiated adjustments recently proposed by the European Commission in respect of tax rulings that it concluded to be incompatible with European Union (the "**EU**") state aid law.[4] The proposed new splitter arrangements, however, would apply to any foreign-initiated adjustment of foreign income taxes of a section 902 corporation, provided the additional foreign tax liability exceeds $10 million. In addition, the Notice explicitly states that no inference is intended as to whether payments made pursuant to foreign-initiated adjustments to the foreign tax liability as a result of decisions by the European Commission under EU state aid law qualify as payments of creditable foreign income taxes for purposes of the U.S. foreign tax credit regime.[5]

The regulations would apply to foreign income taxes paid on or after September 15, 2016.

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[2] 2016-40 I.R.B. 425 (Oct. 3, 2016).

[3] Section references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and the regulations thereunder.

[4] *See* European Commission, *Statement by Commissioner Vestager on state aid decision that Ireland's tax benefits for Apple were illegal* (Aug. 30, 2016); *see also* U.S. Dept. of the Treasury, *The European Commission's Recent State Aid Investigation of Transfer Pricing Rulings* (Aug. 24, 2016); Letter from Jacob J. Lew, U.S. Secretary of the Treasury, to Jean-Claude Juncker, President of the European Commission (Feb. 11, 2016).

[5] *See* Treas. Reg. § 1.901-2(a).

I. BACKGROUND

The new splitter arrangements would come into existence if a section 902 corporation[6] pays "covered taxes" as a result of

(1) a "covered transaction" (a "**Covered Transaction Splitter Arrangement**") or

(2) a "covered distribution" (a "**Covered Distribution Splitter Arrangement**", and together with the Covered Transaction Splitter Arrangement, the "**Section 905(c) Splitter Arrangements**"),

both as described more fully below. "**Covered taxes**" are foreign income taxes that result from an adjustment, or a series of related adjustments, to the foreign tax liability of the section 902 corporation (the "**payor**") in excess of $10 million, that was initiated by a foreign government with respect to one or more prior taxable years (each, a "**relation-back year**"), where the resulting foreign income taxes are taken into account by adjusting, pursuant to section 905(c), the payor's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the taxable year paid.

In general, under section 901, a domestic corporation is entitled to a credit against its U.S. federal income tax ("**U.S. tax**") liability for foreign income taxes if directly paid, subject to the limitations generally applicable under section 901 through 909. Under section 902, a domestic corporation that owns 10 percent or more of the voting stock (a "**section 902 shareholder**") of a foreign corporation (a "**section 902 corporation**"), and receives a dividend from that section 902 corporation, is treated as having paid a portion of the foreign income taxes paid by the section 902 corporation and is entitled to a corresponding amount of foreign tax credits, subject to limitations generally applicable under section 901 through 909. With respect to taxable years of the section 902 corporation after 1986, the amount of foreign income taxes bears the same ratio to all of the post-1986 foreign income taxes paid or accrued by the section 902 corporation, to the extent not treated as previously distributed (the "**post-1986 foreign income tax pool**"), as the amount of the dividend bears to the earnings and profits of the section 902 corporation accumulated after 1986, to the extent not previously distributed (the "**post-1986 undistributed earnings pool**").[7] Thus, a dividend of 35 percent of the payor's post-1986 undistributed earnings would

[6] Under Section 909(d)(5), a "section 902 corporation" is any foreign corporation having one or more domestic corporations owning 10 pcercent or more of the voting stock, directly or under Section 902(b), in that foreign corporation. Thus, section 902 corporations include controlled foreign corporations. *See* Section 951(b).

[7] Rules applicable to pre-1987 taxable earnings and foreign taxes employ a last-in, first-out method on an annual basis. Foreign earnings and foreign income taxes in respect of post-1986 taxable years, but before a foreign corporation first becomes a section 902 corporation, should be treated as pre-1987 earnings and

bring with it a deemed paid credit of 35 percent of the post-1986 foreign income taxes of the section 902 corporation.[8] These pools of earnings and taxes must also be maintained at each lower-tier foreign subsidiary so long as it belongs to a qualified group under section 902.[9] Distributions and deemed distributions by a lower-tier section 902 corporation to an upper-tier section 902 corporation that owns 10 percent or more of the lower-tier section 902 corporation's voting stock similarly results in a deemed payment by the upper-tier corporation of the lower-tier corporation's foreign income taxes, which is then reflected in the upper-tier corporation's post-1986 foreign income tax pool. Section 902 rules also apply with respect to inclusions of subpart F income of a controlled foreign corporation by a corporate United States shareholder.[10]

Section 905(c) requires the IRS to redetermine the amount of U.S. tax if a taxpayer's foreign tax liability for a prior year changes and the tax is not paid within two years of the close of the taxable year to which the foreign tax relates. While generally foreign income taxes are taken into account when accrued, foreign taxes deemed paid under section 902 or section 960 that are actually paid after that two-year period are taken into account for the taxable year in which actually paid (and if paid in a currency other than the U.S. dollar, are translated into the U.S. dollar at the spot rate in effect when paid).

Section 905 and the Treasury regulations thereunder do not address how additional payments of foreign income taxes or a section 902 corporation's earnings should be taken into account or adjusted if an additional payment of foreign income taxes is made by a person different from the section 902 corporation that would have paid the tax in the relation-back year to which the additional tax relates. A change in payor could result, for example, from a liquidation, a reorganization, or another corporate transaction. As described below, in the case of covered transactions and covered distributions, such a change breaks the identity of, and creates a split between, the payor of the additional foreign income taxes and the person that has taken into ac-

foreign income taxes for purposes of section 902. Section 902(c)(3); Treas. Reg. §1.902-1(b)(2)(ii); *see* CCA 2014-44-039 (May 28, 2014).

[8] Under section 78, the amount of foreign income taxes of the section 902 corporation that are deemed paid by the section 902 shareholder is included in the income of the section 902 shareholder.

[9] In addition to a first-tier section 902 corporation, a qualified group consists of foreign corporations down to the sixth tier, provided that (a) the section 902 shareholder owns at least 5 percent of the voting stock of the lower-tier corporation indirectly through the chain and (b) the immediately higher-tier section 902 corporation owns at least 10 percent of the voting stock of the lower-tier corporation. In addition, each section 902 corporation below the third tier must be a controlled foreign corporation and the relevant section 902 shareholder must be a "**United States shareholder**" (within the meaning of section 951(b)) of that corporation. Section 901(b).

[10] Section 960.

count the related foreign income, if section 905(c) is construed to require that the foreign income taxes are in fact taken into account by the payor and not by the person that originally took into account the related foreign income.

Section 909 of the Code was enacted in 2010, effective for taxable years beginning after 2010, in an attempt to restrict what had been perceived as an inappropriate practice of foreign tax credit splitting with respect to foreign income taxes paid or accrued by a taxpayer or section 902 corporation. Generally, there is a "foreign tax credit splitting event" with respect to those taxes if the related income is (or will be) taken into account by a covered person.[11] If such a foreign tax credit splitting event occurs, the affected foreign income taxes (the "**split taxes**") may not be taken into account for U.S. tax purposes until the taxable year in which the related income is also taken into account by the same taxpayer or, in the case of split taxes paid or accrued by a section 902 corporation, by a section 902 shareholder of that corporation.[12] Treasury regulations promulgated under section 909 limit foreign tax credit splitting events to situations in which the foreign income taxes and related foreign income are separated as the result of one of four identified "splitter arrangements."[13]

Redeterminations of the foreign income tax liability of a section 902 corporation under section 905(c) can result in a separation of foreign income taxes and related foreign income if, as a result of certain corporate transactions or distributions between the time the foreign income is realized and the time the foreign-initiated adjustment to the related foreign income taxes is actually paid, the payor of the foreign income taxes is not the same person (as determined for U.S. tax purposes) as the person that reflected the related foreign income in its pool of post-1986 undistributed earnings. As a technical matter under the existing section 909 regulations, no splitting event occurs unless the underlying separation of tax from income arose from a splitter arrangement. The Notice proposes the recognition of two new splitter arrangements, in addition to the existing four, and would thereby generate splitting events out of any separation of a significant amount of foreign income taxes from its related foreign income on account of certain redeterminations in accordance with section 905(c).

More specifically, a Covered Transaction Splitter Arrangement is present if a section 902 corporation pays covered taxes as a result of a "**covered transaction**"; *i.e.,* a transaction (or se-

[11] A "**covered person**," with respect to a payor section 902 corporation is (1) any entity in which the payor holds (directly or indirectly) at least a 10 percent ownership interest (by vote or value); (2) any person that holds, directly or indirectly, at least a 10 percent ownership interest (by vote or value) in the payor; or (3) any person that is 50 percent related to the payor as described in section 267(b) or section 707(b). Section 909(d)(4); Treas. Reg. § 1.909-1(a)(4).

[12] Treas. Reg. § 1.909-2(a).

[13] *See* Treas. Reg. § 1.909-2(b).

ries of related transactions) (1) in which the payor of the covered taxes is distinct from the person that would have been the payor if the foreign income tax had been accrued or paid in the relation-back year; (2) where the hypothetical predecessor payor is a covered person with respect to the actual payor as determined immediately prior to the transaction (or series of related transactions); and (3) that does not result in the transfer of the earnings and profits of the hypothetical predecessor payor to the actual payor pursuant to section 381(c)(2).

A Covered Distribution Splitter Arrangement is present if a section 902 corporation pays covered taxes and has made a "**covered distribution**"; *i.e.,* a distribution (1) made with respect to the section 902 corporation's stock in or after a taxable year to which the covered taxes relate (prior to or in the taxable year the covered taxes are paid) and (2) resulting in a distribution or allocation of the payor's post-1986 undistributed earnings to a covered person that is a section 902 corporation ("**section 902 covered person**").

Each of these Section 905(c) Splitter Arrangements also requires that the relevant covered transaction or covered distribution be made with a principal purpose of separating covered taxes from the post-1986 undistributed earnings to which the covered taxes relate (the "**principal purpose requirement**"). The Notice does not further elaborate on factors indicating a principal purpose with one exception. In the case of a covered distribution, the distribution is presumed to be made with this principal purpose if the sum of all distributions that would be covered distributions (without regard to the principal purpose requirement) is greater than 50 percent of the sum of (1) the payor's post-1986 undistributed earnings as of the beginning of the payor's taxable year when the covered tax is paid and (2) the aggregate distributions that would be covered distributions (without regard to the principal purpose requirement). A taxpayer may rebut the presumption of a principal purpose only by demonstrating its absence by clear and convincing evidence.

Section 3.01 of the Notice illustrates a Covered Transaction Splitter Arrangement. Domestic corporation USP wholly owns CFC1, which in turn wholly owns CFC2, each a foreign corporation formed at the beginning of Year 1 and tax resident in Country X. CFC1 also wholly owns DE, a disregarded entity for U.S. tax purposes that is organized in, and treated as a tax resident corporation by, Country X. DE earns $200 per year in Year 1 through Year 5, but accrues no foreign income taxes. In Year 6, CFC1 transfers DE to CFC2 in exchange for CFC2 stock in a section 351 transaction. In Year 8, DE pays $200 in foreign income tax in respect of Year 1 through Year 5 pursuant to a foreign-initiated adjustment. The example states that, if the principal purpose requirement is satisfied, CFC1's contribution of DE to CFC2 is a covered transaction and the foreign-initiated adjustment in Year 8 gives rise to a Covered Transaction Splitter Arrangement.

Section 3.02 of the Notice illustrates a Covered Distribution Splitter Arrangement. Domestic corporation USP wholly owns CFC1, which in turn wholly owns CFC2, both of which are

foreign corporations formed at the start of Year 1 and tax resident in Country X. CFC2 earns $100 of earnings and profits for each of Year 1 through Year 9 and distributes $750 of its $900 of post-1986 undistributed earnings to CFC1 in Year 11 (which under section 954(c)(6) does not constitute subpart F income to USP). In Year 12, CFC2 pays $180 of additional tax relating to income it earned in Year 1 through Year 9. Under section 905(c), this increases CFC2's pool of post-1986 foreign income taxes in Year 12 and results in a Covered Distribution Splitter Arrangement, unless CFC2 establishes by clear and convincing evidence that the $750 distribution in Year 11 was not made with a principal purpose to reduce its post-1986 undistributed earnings in advance of the payment of covered taxes.

II. SUMMARY OF RECOMMENDATIONS

The Tax Section concurs in the Treasury's concern that long-delayed foreign-initiated adjustments, like the ones proposed in recent EU state aid law decisions, make the conventional U.S. foreign tax credit system difficult to administer. For reasons set forth below, we recommend that any regulations issued pursuant to the Notice reflect the considerations discussed below.

(1) The Treasury and the IRS should consider issuing regulations under section 905(c) to address long-delayed foreign-initiated adjustments in a manner that avoids the separation of foreign income from foreign income taxes. Specifically, for transactions that under the Notice would constitute Covered Transaction Splitter Arrangements, the Treasury and the IRS should consider an approach where the additional foreign income taxes are to be reflected in the foreign income tax pool of the person that would have been the payor in the relation-back year, and that appropriate adjustments are made if deemed payments between this person and the actual payor have to be reflected. Similarly, we recommend that, with respect to distributions that under the notice would constitute Covered Distribution Splitter Arrangement, the Treasury and the IRS consider making simultaneous adjustments to the foreign tax pools of the distributor and distributee (and any intermediate distributees) together with appropriate adjustments to the amount distributed.

If the Treasury and the IRS conclude that Section 905(c) Splitter Arrangements remain necessary for the proper administration of the foreign tax credit regime because they believe that certain transactions cannot be appropriately addressed through adjustments under section 905(c) as proposed above, we further recommend the following with respect to Section 905(c) Splitter Arrangements:

(2) The examples in sections 3.01 and 3.02 of the Notice do not appear to present an abusive separation of foreign income taxes from related foreign income.

Rather, only cross-chain transfers (of the lower-tier technical taxpayer after a distribution of its earnings or a disregarded entity or hybrid partnership interest) or repatriations to a section 902 shareholder would allow for the separate repatriation of the foreign tax pool without also repatriating the related foreign earnings. Future examples should clarify this.

(3) The Treasury and the IRS should consider using a lower, annual threshold in lieu of the $10 million threshold for adjustments, or series of related adjustments, in order to avoid the need to determine whether several adjustments over a period of years (or in relation to the same year) by the same or different taxing authorities are parts of a series of related adjustments.

(4) The principal purpose requirement should not be regarded as satisfied if the taxpayer shows its absence by a preponderance of evidence, not by the higher standard of clear and convincing evidence. We are concerned that, in practice, a principal purpose presumption would operate as an irrebuttable presumption under a clear-and-convincing-evidence threshold of proof because the threshold for rebuttal would be too high for proving a negative. We believe that taxpayers should be allowed to introduce evidence under general preponderance-of-evidence criteria. We also think certain safe harbors would be justified.

III. DISCUSSION

The Notice reserves judgement on whether payments of adjustments made pursuant to recent EU state aid decisions will in fact be regarded as giving rise to creditable foreign income taxes for U.S. tax purposes. For the sake of discussion, this report will assume that these EU state aid adjustments, like other long-delayed adjustments, would give rise to creditable foreign income taxes.

A. Applying Section 905(c) to Avoid Splitter Arrangements

The Notice asked for comments on whether 905(c) Splitter Arrangements would be more appropriately addressed under the section 905(c) rules. We believe that Treasury's primary objective would be achieved by procedures that prevent long-delayed foreign adjustments from creating a separation of foreign income tax payments from the related income in the first place. For the reasons below, we believe that rules under section 905(c) provide in fact a more appropriate mechanism to ensure that this separation does not occur in the case of covered persons.

1. Covered Transaction Splitter Arrangements

The potential for abuse that the Notice identifies for Section 905(c) Splitter Arrangements critically turns on the peculiarities of the section 905(c) redetermination mechanism. Section 905(c) is therefore the preferable place for a solution to the potential distortion that it enables. It is also strongly preferable because a one-time adjustment pursuant to a redetermination should be in general more easily complied with than the multi-year, and possibly open-ended, tracking of split taxes and related foreign income that is required under the accounting procedures of section 909. In addition, as we have pointed out in prior reports, the section 909 procedures can leave a taxpayer in a situation where it is never able to avail itself of a credit for foreign income taxes after they have become split taxes, even though the taxpayer has borne the economic burden of paying them.[14]

That foreign-initiated adjustments paid two or more years after the relation-back year can give rise to a Covered Transaction Splitter Arrangement is based on a particular interpretation of section 905(c) and the technical taxpayer rule. The technical taxpayer rule, as relevant here, states that for foreign tax credit purposes, a foreign income tax is considered paid by the person on whom foreign law imposes legal liability for the tax. This rule applies "even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability."[15] Further, in the case of a disregarded entity, the person that "is treated as owning the assets of the disregarded entity for U.S. Federal income tax purposes is considered to the legally liable for such tax under foreign law."[16]

Section 905(c)(1)(B) provides in relevant part:

> If...accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate…the taxpayer shall notify the Secretary, who shall redetermine the amount of the tax for the year or years affected…[and] may prescribe adjustments to the pools of post-1986 foreign income taxes and the pools of post-1986 undistributed earnings under sections 902 and 960….

Section 905(c)(2)(B) provides in addition:

> Any such taxes if subsequently paid…shall be taken into account…in the case of taxes deemed paid under section 902 or section 960, for the taxable year in which paid….

[14] *See* N.Y. St. B. Ass'n, Tax Sec., *Report on Temporary and Proposed 'Splitter' Regulations and Final Technical Taxpayer Regulations,* (Rep. No. 1273, Oct. 2, 2012), at V.B. 1, 7, 8 and 9.

[15] Treas. Reg. § 1.901-2(f)(1) and (2).

[16] Treas. Reg. § 1.901-2(f)(4)(ii).

The example in section 3.01 of the Notice indicates that the Treasury and the IRS interpret the section 905(c) provisions as requiring the adjustment to be made by the section 902 corporation (or section 902 shareholder) that actually pays the taxes, *i.e.,* applying the technical taxpayer rule as of the time the tax payment is made. Although the regulations do not specifically state it, the person that is treated as owning the assets of the DE under U.S. tax law at the time the foreign income tax is paid or accrued is the technical taxpayer, not the person that was treated as owning the assets of the DE at the time the foreign income was accrued.[17]

In a Covered Transaction Splitter Arrangement, the apparent transfer of legal liability from one person to another is in general the result of the check-the-box rules under which a hybrid entity is created. This would be the case not only in a transfer of DE, as in the example in section 3.01 of the Notice, by CFC1 to its subsidiary CFC2, but also in a sale by CFC1 of DE to another controlled foreign corporation wholly owned by USP, the U.S. parent, in a cross chain sale.

The technical taxpayer rule and the section 905(c) payor rule are largely rules intended to further the administrability of the foreign tax credit regime. In combination with the check-the-box regime, however, they give rise to the potential of creating split taxes. This potential for foreign tax credit splitting as a result of redeterminations is not dependent on the existence of hybrid disregarded entities, it arises also with respect to hybrid partnership structures.[18]

We believe that the Treasury and the IRS should consider whether the Covered Transaction Splitter Arrangement should be recast so that these rules of administrative "convenience" do not result in unnecessary splitter arrangements, do not force taxpayers to comply with the complicated tracking required under section 909, and do not allow taxpayers (absent adding Section 905(c) Splitter Arrangements to the section 909 universe) to separate foreign taxes from foreign income.

Section 905(c) notably does not state whose pools of foreign income and foreign taxes are to be adjusted. And while no foreign tax credit may be taken before the taxable year when a

[17] An exception is explicitly provided for the case of a transfer of a disregarded entity when the taxable year for purposes of foreign tax law does not close at the end of the date of transfer. In the case of such a transfer, a portion of the foreign tax is reallocated to the transferor. This in effect prevents the creation of small splitting events where earnings and profits for the pre-transfer stub period remain lodged with the transferor while under the technical taxpayer rule all related foreign income taxes would be allocated to the transferee. *See* Treas. Reg. § 1.901-2(f)(4)(ii); *see also* Treas. Reg. §§ 1.338-9(d), 1.336-2(g)(3)(ii) and 1.901-2(f)(4)(i).

[18] Under Treas. Reg. § 1.901-2(f)(4)(i), a hybrid partnership is treated as the payor of taxes for U.S. tax purposes if it is legally liable for the foreign taxes under foreign law; creditable foreign taxes are allocated to the partners for U.S. tax purposes under the rules of Treas. Reg. § 1.704-1(b)(4)(viii).

long-delayed foreign-initiated adjustment is actually paid, there is no prohibition against adjustments to post-1986 foreign income tax pools and post-1986 undistributed earnings pools that trace back to the relation-back years to which the additional foreign taxes relate.

We therefore believe that the Treasury and the IRS have, and should fully exercise, authority to make appropriate adjustments to the relevant tax and earnings pools under section 905(c) to prevent the emergence of split taxes as a result of foreign-initiated adjustments, consistent with the general purpose of section 905. More specifically, instead of creating a Covered Transaction Splitter Arrangement, the section 902 corporation that originally reflected the related foreign income in its post-1986 earnings pool should reflect an adjustment to its post-1986 foreign income tax pool. The actual payor, by contrast, would not reflect the foreign tax payment in its post-1986 foreign income tax pool (or as a foreign tax credit, in case of a direct foreign tax credit) as a result of the redetermination if it is different from the original section 902 corporation. This would avoid the creation of split taxes in the first place, and section 909 would not be implicated as a result of what would otherwise constitute a covered transaction.

The fact that the foreign tax is actually paid by another person (as determined for U.S. tax purposes) would have to be correspondingly recharacterized. In the example in section 3.01 of the Notice, the foreign income of disregarded entity DE was originally accrued by CFC1. After DE is transferred to CFC2, DE's subsequent payments of foreign-initiated adjustments of tax in respect of income originally accrued to CFC1 would result in an adjustment to CFC1's post-1986 foreign income tax pool. DE is in effect treated as making a payment of taxes on behalf of the entity that would have been treated as the taxpayer in the relation-back year. Accordingly, DE's tax payment should in our view be treated as a distribution from DE and CFC2 to CFC1.

Similarly, after a cross-chain sale of a disregarded entity that is a taxpayer in the relevant country, if the transferor section 902 corporation has agreed to indemnify the transferee-payor of the foreign-initiated adjustment, there should be no further adjustment and the transferee-payor should be akin to a paying agent of the transferor. In other cases, there would have to be an adjustment of the purchase price in a cross-chain sale or possibly a series of distributions by the payor and contributions by the transferor. Such collateral or correlative adjustments are well developed under section 482 to reflect adjustments among related taxpayers.

Adjustments should be similarly made if a refund of foreign tax is paid, as an anticipated large refund might similarly open up the potential for separating foreign tax pools from foreign income pools. Adjustments to the pool of post-1986 foreign income and foreign income taxes therefore could likewise obviate the creation of a split taxes through transactions involving the entity that is or becomes entitled to a refund of foreign income taxes.

We also believe that the potential for creating split taxes is not limited to the deemed foreign tax credit under section 902, but also arises for U.S. taxpayers claiming a direct tax credit

under section 901, and that this potential also includes situations involving refunds. For example, assume that domestic corporation USP has earned foreign income and paid related foreign taxes in Year 1 through its branch in country *X*, which is operated through a disregarded entity DE that is organized and treated as tax resident in country *X.* In Year 3, USP elects to "check the box" to treat DE as a (foreign) corporation for U.S. tax purposes or contribute DE to a wholly owned controlled foreign corporation in anticipation of a large refund of Year 1 country *X* income taxes on account of an expected loss carryback by DE from Year 3 to Year 1. DE (now (part of) a controlled foreign corporation for U.S. tax purposes) files an amended country *X* tax return with respect to Year 1 in Year 4 and receives a refund in Year 5. Section 905 and the 2007 temporary regulations thereunder do not address how this case is to be handled. Under the section 905(c) adjustments outlined above, DE would be treated as in effect having received a payment on behalf of USP, and USP should have to reduce the amount of its foreign tax credits and be treated as having contributed the amount of the refund to (no longer disregarded) DE.

2. Covered Distribution Splitter Arrangements

The same considerations are relevant to Covered Distribution Splitter Arrangements. Temporary regulations issued under section 905(c) in 2007, which expired on November 6, 2010, already provide that

> If a lower tier foreign corporation receives a refund of foreign tax after making a distribution to an upper tier foreign corporation and the refund would have the effect of reducing below zero the lower tier corporation's pool of foreign taxes in any separate category, then both the lower tier and upper tier corporations shall adjust the appropriate pool of foreign taxes to reflect that refund.[19]

The temporary regulations show that these adjustments up the chain can be made by decreasing the upper-tier corporation's foreign tax pool, correspondingly increasing that of the lower-tier corporation and then reducing the lower-tier corporation's foreign tax pool by the amount of the refund "as if the refund occurred prior to the distribution."[20] The same authority under section 905(c) extends in our view to a foreign-initiated *increase* in foreign taxes.

Section 905(c) itself does not require that the adjustment to the foreign tax and foreign earnings pools be made in only that year. Thus, even if the adjustment is made in the year the foreign tax is actually paid, the adjustment in the relevant pools can still be made in a manner that traces the actual distributions. As a result, post-1986 foreign income tax pools are not sepa-

[19] Temp. Treas. Reg. § 1.905-3T(d)(2)(ii)(C).

[20] Temp. Treas. Reg. § 1.905-3T(d)(2)(ii)(C).

rated from post-1986 undistributed earnings pools from the time that the latter have (in whole or in part) been moved on account of a distribution, in accordance with the rules under section 902.

If a portion of foreign earnings has been distributed to a U.S. taxpayer that can claim a deemed-paid foreign tax credit, a foreign-initiated adjustment may result in an increased amount of foreign taxes available for a foreign tax credit in the year of the payment of the additional foreign taxes. This may lead to a difference between the time when (a portion of) the foreign tax is taken into account and the time when the foreign earnings are taken into account. However, no foreign tax credit could be claimed in respect of foreign earnings that have not already been taken into income by the U.S. taxpayer. While foreign income taxes freshly available for credit without additional concomitant foreign income might allow the U.S. taxpayer to repatriate other, additional foreign earnings without giving rise to an additional U.S. tax liability, we believe that this is not abusive and is the opposite of split taxes. Instead, this result would prevent the potential deferral or forfeiture of foreign tax credits related to income already subjected to U.S. tax. The U.S. taxpayer, after all, either has paid residual U.S. tax on the distribution when originally repatriated or would have had an excess foreign tax credit in the year of distribution. An unfair benefit to such a U.S. taxpayer is therefore not apparent to us.

Covered distributions and covered transactions also could be combined. For example, assume that USP wholly owns CFC1 and CFC3, CFC1 in turn wholly owns CFC2, and CFC2 wholly owns the disregarded entity DE. Each of USP's subsidiaries is organized and tax resident in country *X*. Assume further that CFC2 makes a distribution to CFC1, which moves CFC2's post-1986 undistributed earnings pool to CFC1, and that CFC2 then sells DE to CFC3. Sometime after this cross-chain sale, the tax authorities of country *X* make a foreign-initiated adjustment of DE's foreign income taxes. In this case, CFC2, and not CFC3 (through DE), should be subject to adjustments in its post-1986 foreign income tax pool, as described above with respect to "covered transactions" and the distribution should then require the appropriate correlative adjustment between CFC2 and CFC1, as well as adjustments (such as a purchase price adjustment) to reflect DE's cash tax payment on behalf of the original taxpayer, CFC2.

If before DE's payment of the foreign taxes CFC1 had distributed to USP all or a portion of the post-1986 undistributed earnings that it received from CFC1, USP should, in proportion to the distributed post-1986 earnings, be able to claim a foreign tax credit with respect to the additional foreign income taxes paid by DE, but only for the year in which the foreign taxes were actually paid.

Utilizing authority under section 905(c) to the greatest degree possible and making collateral adjustment should minimize the separation of foreign income tax from related income and thus, the opportunity for abusive splitting events. We believe that this approach is consistent with section 905(c) and avoids the complications of accounting for split taxes between covered persons.

3. Residual Foreign Tax Credit Splitters

Assuming that section 905(c) authority is fully exercised, the need for the identification of new splitter arrangements under section 909 would be limited to abusive splitter cases that the Treasury and the IRS believe to be outside the scope of their authority under section 905.

If a section 902 corporation sold a disregarded entity to an unrelated party, for example, it might be difficult to make adjustments. While under the section 905(c) notification requirement the transferred disregarded entity would have to notify the IRS of the foreign adjustment (provided it is owned by a section 902 corporation or a U.S. taxpayer), an adjustment between otherwise unrelated persons seems inappropriate. A transfer to an unrelated person, however, should also not be a Section 905(c) Splitter Arrangement, because the owner of the transferred disregarded entity would not be a covered person with respect to the transferor section 902 corporation.[21] The scope of our proposed section 905(c) approach would not seem to be narrower than the scope of Section 905(c) Splitter Arrangements if unrelated-person transactions or distributions are not made subject to section 905(c) adjustments in the manner outlined above.

We note, however, that the Notice seems to produce one potential anomaly: while a direct transfer of a disregarded entity to an unrelated person should not qualify as a splitting arrangement as the deemed payor is not a covered person with respect to the transferor, the Notice appears unclear with respect to certain two-step transfers. For example, assume that CFC1, a section 902 corporation, first transfers its disregarded subsidiary DE to its regarded subsidiary CFC2 that is also a section 902 corporation, CFC1 then transfers CFC2 to an unrelated acquiror, and DE then becomes liable for a foreign-initiated adjustment. A Covered Transaction Splitter Arrangement could arise in this case because CFC1 (the predecessor entity within the meaning of the Notice) and CFC2 (the payor of the post-transfer foreign-initiated adjustment) were covered persons immediately before the transaction, if the transfer to the unrelated person were found to be part of a series of related transactions.

Likewise, if DE were owned by CFC2 and, first, CFC2 distributed its earnings to CFC1 and, then, CFC1 sold all of the stock of CFC2 to an unrelated person, post-transfer accrued foreign taxes paid by CFC2 (through DE) pursuant to a foreign-initiated adjustment with respect to one or more pre-transfer taxable years also appear to be split taxes as a result of a Covered Distribution Splitter Arrangement. This should be the case because at the time of distribution CFC1 and CFC2 were covered persons with respect to each other.

However, if CFC2 transferred DE to the unrelated person, the unrelated person (as the new owner of DE) would not be a covered person either before or after the transfer. Future guid-

[21] *See* Section 909(d)(1).

ance should clarify whether these transactions are to be treated differently. If the transactions and distribution described above are intended to qualify as Section 905(c) Splitter Arrangements and are considered to be outside the scope of authority for a section 905(c) approach to avoiding the creation of split taxes, they appear to justify a residual category where section 909 should apply.

The remainder of this report will concern the application of the proposed foreign tax credit splitter rules if those rules are considered necessary to deal with the separation of foreign income tax and foreign income for cases outside the scope of the Treasury's authority under section 905(c).

B. The Examples in the Notice Are Incomplete or Do Not Depict Abuse

To the extent a splitter rule remains necessary after any permissible section 905(c) authority is exercised, we believe the splitter identification should be limited to situations presenting abuse opportunities. The example in section 3.01 of the Notice describes splitter arrangements arising from the application of section 905(c) where the foreign tax is ultimately paid by a successor entity (to CFC1) owned by a subsidiary of CFC1 (CFC2). Thus, while the post-1986 undistributed earnings pool stays with CFC1, the post-1986 foreign income tax pool of CFC2 increases. The example in section 3.02 has the same ultimate effect, where the additional foreign tax pursuant to a foreign-initiated adjustment is paid by CFC2 in Year 12 while (a portion of) the post-1986 undistributed earnings pool has moved up to CFC1.

It is unclear where the abuse is in the case of a splitting event within the same chain of foreign subsidiaries.[22] In order for CFC2's foreign tax to be available for a foreign tax credit in the United States, CFC2 would have to make an additional distribution to CFC1 in order to "move up" the post-1986 foreign income tax pool, and CFC1 would then have to make a distribution to its U.S. Parent USP. Under the "anti-hopscotch" rule of section 960(c), it is no longer possible to make a deemed direct distribution from CFC2 to USP under section 956 by way of an investment in United States property; *i.e.,* the deemed distribution does not attract more foreign income taxes deemed paid than a series of direct distributions through the chain of ownership. The examples therefore fail to illustrate a situation that is on its face abusive and to implicate the policies underlying section 909.

[22] An exception would be the case where CFC2, as owner of DE, distributes the equity interests in DE to CFC1 prior to a foreign-initiated adjustment and if DE's distribution moves up a comparably small amount of post-1986 undistributed earnings (*e.g.*, because it is has a low value). In that case, the foreign-initiated adjustment might boost CFC1's pool of post-1986 foreign taxes without a corresponding increase in its pool of foreign earnings.

Section 909 may be implicated, however, if, after the type of transaction illustrated by the examples, the entity liable for payment of the foreign taxes pursuant to the foreign-initiated adjustment would merge with, be contributed to, or sold to an entity in a separate chain of foreign corporations. Such a transfer would likely preserve CFC2's tax attributes, including its post-1986 foreign income tax pool (including the effects of the foreign initiated adjustment). Thereafter, in the new chain of foreign corporations, CFC2's taxes could be distributed up the chain to the U.S. parent USP without USP taking into account the distributed portion of the related foreign income, which would continue to be reflected in the post-1986 undistributed earnings pool of CFC1. Similarly, if CFC1 were to spin off CFC2 in a non-recognition transaction, or in transactions subject to section 304 (*e.g.*, a purchase of an affiliate by CFC2), this abuse potential could arise. If the Treasury and the IRS were to issue regulations under section 909 defining new Section 905(c) Splitter Arrangements, we suggest that such transactions creating a potential for abuse could be made an essential element of splitter identification. In any event, further examples should be provided that more fully illustrate the potential of covered transactions and covered distributions to create abusive foreign tax splitting events.

C. $10 Million Threshold for Covered Taxes

A foreign-initiated adjustment of foreign taxes gives rise to a Section 905(c) Splitter Arrangement only if it is an adjustment, or a series of related adjustments, to the foreign tax liability of the payor in excess of $10 million. The threshold introduces an element into the determination of splitting arrangements not present in the existing four splitter arrangements, which apply regardless of the amount of split taxes or the amount at issue in the underlying transactions or arrangements giving rise to split taxes.

There is no further explanation in the Notice when adjustments would be part of a series of related adjustments. Would all adjustments pursuant to a single audit be treated as "related" for this purpose? And what conditions, if any, would appropriately relate adjustments from separate audits, with respect to separate years, or potentially even for separate jurisdictions if there are correlative adjustments with respect to a foreign-initiated adjustment by one jurisdiction that affect the tax liability of the same or a related taxpayer in another?[23] If regulations were to keep this concept, we recommend that the Treasury and the IRS elaborate on what factors or other relationships would make adjustments related for this purpose.

[23] This might, for example, happen in the case of a transfer pricing dispute involving two foreign jurisdictions.

We prefer, however, and we believe it would be administratively easier, to introduce a *per annum* threshold limited to the specific taxpayer. The need to determine whether foreign-initiated adjustments are related would then fall away.

As the proposed adjustments pursuant to EU state aid law determinations would cover a ten-year period, an annual threshold of $1 million might be a reasonable simplification. This approach would categorize some adjustments as covered taxes that the Notice would not so categorize. For example, a series of related adjustments relating to three taxable years of the payor in the amount of $3 million per year would not result in covered taxes under the Notice, because the $10 million limit is not exceeded. By contrast, with an annual threshold of $1 million, each year would give rise to $3 million of covered taxes under the *per annum* approach proposed here.

Both thresholds could also be introduced as alternatives. Covered taxes would in that case not arise unless the taxpayer would exceed the threshold only if the adjustment or series of related adjustments exceed $1 million per year or $10 million in the aggregate. This approach, however, would still require the determination of "series of related adjustments."

D. Principal Purpose Exception

The Notice specifically excepts from Section 905(c) Splitter Arrangements covered transactions and covered distributions where the section 902 corporation can "demonstrate by clear and convincing evidence that the transaction or series of related transactions were not structured with a principal purpose of separating covered taxes from the post-1986 undistributed earnings of the predecessor entity…to which the covered taxes relate." The Treasury and the IRS asked whether an objective test, rather than a subjective test based on taxpayer intent, should be used to determine the presence of Section 905(c) Splitter Arrangements.

A substantial number of our members believes that the principal purpose test should be dropped. An objective test, *i.e.*, the absence of a principal purpose test, would be consistent with the general absence of intent-based tests in the current foreign tax credit regime, including the definition of the existing four splitter arrangements. Objective tests often simplify tax administration, are conducive to orderly tax planning, and discourage inappropriate tax planning. Section 905(c) Splitter Arrangements with a principal purpose test would therefore be an apparent exception to the general approach of section 909. Further, it is not clear why the splitting of foreign taxes from foreign earnings in Section 905(c) Splitter Arrangements should be inappropriate based on the underlying planning of taxpayers and why in some cases taxpayers should be able to enjoy an advantage solely because of the absence of planning. Rather, if the splitting of significant amounts of foreign taxes as a result of section 905(c) redeterminations is inappropriate in some cases, it arguably ought to be inappropriate in all cases.

Other members are of the view that a principal purpose test is suitable here. Existing splitter arrangements arguably exhibit *per se* a principal purpose of separating foreign taxes from foreign income as they require specific planning and transactions that will result in the splitting of taxes that could otherwise be avoided by the taxpayer or section 902 corporation.[24] Unlike the existing splitter arrangements, however, which implicate the presence of a principal purpose transaction or planning, Section 905(c) Splitter Arrangements may result from adjustments and redeterminations after covered transactions or covered distributions that were undertaken without any intention or planning relating to foreign tax credit management when the taxpayer or section 902 corporation did not know that a future foreign-initiated adjustment might occur at the time of the distribution or transfer. These members agree with the Notice that an intent-based standard is appropriate for Section 905(c) Splitter Arrangements.

In any case, however, the majority believes that if an intent-based test is adopted, the standard for rebutting the presence of a principal purpose should be less stringent than the clear and convincing evidence standard. This standard is generally thought to have originated in situations designed to protect a party against harsh sanctions from factually ambiguous activities. In practice, this might become an irrebuttable presumption or require significant resources by the IRS to determine the presence of such a principal purpose and the probative value of evidence to the contrary. Thus the standard appears to offer false hope that transactions can escape the taint of being a Section 905(c) Splitter Arrangement, to prompt more taxpayer disputes, and to create the need to account of contingent tax liabilities. We therefore believe that a less onerous preponderance of evidence standard would be appropriate for rebutting a principal purpose requirement of covered transactions and covered distributions.

In addition, if 905(c) Splitter Arrangements together with a principal purpose presumption were added to the inventory of foreign tax credit splitter arrangements under section 909(c), certain fact patterns should constitute safe harbors that provide *per se* clear and convincing evidence (and *a fortiori* a *per se* preponderance of evidence) of the absence of a motive to separate foreign taxes from foreign income.

The Notice indicates that a taxpayer may rebut, with respect to a Covered Distribution Splitter Arrangement, that the covered distribution had a relevant principal purpose if the distributions are consistent with the payor's pattern of distributions before the taxpayer reasonably anticipated the specified foreign-initiated adjustment. We believe that there should be specific safe harbors for showing such a consistent pattern. First, by analogy to the approach of section

[24] *I.e.*, the use of losses in the case of a loss-sharing splitter arrangement; the use of a reverse hybrid in a reverse hybrid splitter arrangement; the use of a hybrid instrument in the case of a hybrid instrument splitter arrangement; and disproportionate allocations in a partnership inter-branch payment splitter arrangement. *See* Treas. Reg. §1.909-2(b).

1291(b), there should be a consistent pattern if the aggregate amount of distributions during a taxable year does not exceed 125 percent of the average amount distributed in respect of the relevant stock during the preceding three taxable years. Second, any distribution in respect of any class of preferred stock that is in accordance with the (non-discretionary) terms of the preferred stock should be treated as consistent with the pattern of distributions. Third, any amount distributed that is within a certain margin of the average amount of after-tax foreign earnings distribut- distributed in the preceding three taxable years should likewise be considered to fall within a consistent pattern.

We also believe that a transaction or distribution should not satisfy the principal purpose requirement if the transaction is entered into, or the distribution is made, at least three years prior to written notification by the relevant foreign tax authority of the foreign-initiated adjustment or, if there is no such prior notification, six months prior to the initiation of the relevant audit by the foreign tax authority. We note that the recent ruling by the European Commission under EU state aid law described above should, for this purpose, be considered a notification and the European Commission a foreign tax authority.

IV. CONCLUSION

We recognize and share the concerns of the Treasury and the IRS about the large amounts of potentially creditable foreign income taxes created by the state aid-based and other long-delayed foreign adjustments. We believe that the potential for splitting foreign income tax from related income inherent in these long-delayed adjustments should be addressed under section 905(c) to avoid the complexity and monitoring resulting from splitter status under section 909. If some residual category of Section 905(c) Splitter Arrangements remains that the Treasury and the IRS believe to be beyond their authority under section 905(c), or if foreign tax credit splitter identification is pursued for all such adjustments, consideration should be given to narrowing the scope of these arrangements as described above.