November 29, 2011

The Honorable Emily S. McMahon
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Report on the Interaction of Section 909 and Subchapter K

Dear Ms. McMahon, Mr. Wilkins and Mr. Shulman:

We are pleased to submit New York State Bar Association Tax Section Report No. 1249. The report responds to the request in Notice 2010-92, 2010-2 C.B. 916 (the "Notice") for comments regarding the regulations governing allocations between partners of creditable foreign tax expenditures incurred by partnerships, specifically, whether the regulations should be amended in light of the enactment of section 909 of the Internal Revenue Code of 1986, as amended (the "Code").

A U.S. partner allocated a creditable foreign tax expenditure is entitled to claim the associated foreign tax credit. The regulations under section 704(b) of the Code governing the allocation of creditable foreign tax expenditures generally respect allocations of creditable foreign tax expenditures that are proportionate to the net income (determined under U.S. federal income tax principles) allocated from the activity that incurred the foreign tax.[1] In the case of creditable foreign tax expenditures imposed on a disregarded inter-branch payment, there is no directly corresponding item of U.S. taxable income. However, a safe harbor in the current regulations respects allocations of creditable foreign tax expenditures that are in proportion to allocations of net income from the payee branch on which the foreign tax is imposed. Other discontinuities between U.S. and foreign tax law in the case of partnerships also can arise, for example, if the partnership makes guaranteed payments under section 707(c) or owns built-in gain or loss property subject to section 704(c), as the foreign tax system may take an approach to such items that is inconsistent with U.S. federal income tax principles and Subchapter K.

Section 909 of the Code may suspend foreign tax credits paid or accrued by a U.S. taxpayer until the related foreign income is taken into account by the taxpayer if there is a "foreign tax credit splitting event." A foreign tax credit splitting event generally occurs under section 909 when foreign income tax is paid or accrued by a taxpayer but the "related income" is taken into account by another person that is related to the taxpayer. The statute contains no detailed guidance on how these rules should apply to creditable foreign tax expenditures incurred by partnerships and allocated to the partners under section 704(b). Section 909(c)(1) merely states that in the case of a partnership, the operative rules are to be applied at the partner level.

We generally support the approach of the current section 704 regulations, which effectively require creditable foreign tax expenditures to be allocated in proportion to the income on which the foreign tax was imposed (to qualify for a safe harbor and avoid the need to allocate creditable foreign tax expenditures based on the partners' interests in the partnership). We believe, however, that there are a few situations in which the current section 704(b) allocation rules permit separation of foreign taxes from the associated income, which could allow taxpayers to manipulate effective foreign tax rates in a manner that implicates the policy concerns of section 909. One way to address this may be revisions to the section 704(b) regulations governing creditable foreign tax expenditure allocations to address these situations.

The report offers several specific recommendations regarding changes to the section 704 regulation governing creditable foreign tax expenditure allocations and related section 909 guidance addressing partnerships:

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[1] Treas. Reg. § 1.704-1(b)(4) & (5).

For reasons explained in the report, we believe potential abuse under the current section 704(b) regulations governing creditable foreign tax expenditure allocations is most likely to occur in the case of disregarded inter-branch payments by partnerships that have related partners. While abuse is theoretically possible even when the partners are not related, for reasons explained in the report, we believe the safe-harbor rule for disregarded inter-branch payments is uneconomic as applied to allocations between unrelated partners and therefore is unlikely to be relied upon by unrelated partners acting at arm's length for commercial reasons. Accordingly, even though we do not believe unrelated partners should be treated as "covered persons" under section 909(c)(1) and therefore do not believe the unrelated partner case is technically subject to section 909 in most situations, consideration should be given to eliminating the rule for disregarded inter-branch payments.

If the rule for disregarded interbranch payments is eliminated we recommend that the current regulations be revised to state expressly that an allocation of creditable foreign tax expenditures that satisfies section 704(b) would satisfy section 909. If the rule for disregarded inter-branch payments is not eliminated, the regulations should instead provide that the fact that an allocation satisfies section 704(b) does not preclude application of section 909 and include examples illustrating the application of section 909 to a partnership with related partners that takes advantage of the rule for disregarded inter-branch payments. We do not believe, however, that the suspension of foreign tax credits under section 909(a) generally should apply to unrelated partners in that situation.

We believe the treatment under the current section 704(b) regulations of guaranteed payments under section 707(c), gross income allocations and built-in gain and loss property either reaches appropriate results from a section 909 perspective or, in the situations in which it arguably results in "separation," is not easily manipulated for tax planning purposes, and therefore requires no revision. We do not believe these situations generally result in foreign tax credit splitting under section 909 and that any abuse is relatively unlikely and can be adequately addressed using other existing anti-abuse provisions.

The report also recommends that separate guidance under section 909 confirm that section 909 applies to partnerships using an aggregate approach and that the "covered person" definition in the partnership context requires that partners be related to each other, rather than to the partnership.

We appreciate your consideration of the Report and our recommendations.

Sincerely,

Jodi J. Schwartz

Cc:

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