REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON THE INTERACTION OF SECTION 909 AND SUBCHAPTER K

Report #1249

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New York State Bar Tax Section

Interaction of Section 909 and Subchapter K

I. Introduction

This report of the Tax Section of the New York State Bar Association[1] responds to the government's request in Notice 2010-92[2] (the "Notice") for comments regarding the regulations governing partnership allocations of creditable foreign tax expenditures ("CFTEs"), 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").[3]

The Notice, which provides interim guidance under section 909, states:

> The Treasury Department and IRS recognize that certain allocations of creditable foreign tax expenditures and income of a partnership can result in the separation of the creditable foreign tax expenditures and the related income for purposes of section 909, notwithstanding that these allocations satisfy the requirements of section 704(b) and the regulations thereunder. See, *e.g.*, § 1.704-1(b)(4)(viii)(*d*) and § 1.704-1(b)(5), *Example 24*. . . . [T]he Treasury Department and IRS will provide in future guidance that allocations described in § 1.704-1(b)(4)(viii)(*d*)(*3*) will result in a foreign tax credit splitting event in post-2010 taxable years to the extent such allocations result in foreign income taxes being allocated to a different partner than the related income. The Treasury Department and IRS solicit comments on the extent to which § 1.704-1(b)(4)(viii)(*d*) and § 1.704-1(b)(5), *Example 24* should be modified in light of the enactment of section 909.

Example 24, referenced by the Notice, involves a partnership that conducts business through two disregarded subsidiaries (each, a "DRE") in different countries and allocates the net income (determined under U.S. tax principles) from the two DREs between the partners in

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[1] The principal author of this report is Andrew Walker, with substantial assistance from Yaron Z. Reich and Eric Sloan. Helpful comments were provided by Kimberly Blanchard, Peter Blessing, Andrew Braiterman, Stephen Land, Matthew Lay, Andrew Needham, Michael Schler, Willard Taylor, and Philip Wagman. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] 2010-2 C.B. 916.

[3] Unless indicated otherwise, all section references in this report are either to the Code or Treasury regulations thereunder. Section 909 was enacted in 2010 as part of the Education Jobs and Medicaid Assistance Act of 2010, P.L. 111-226, 124 Stat. 2389.

different ratios. In the example, there is a transaction between the DREs that is disregarded for federal income tax purposes and the country in which the payee branch is located imposes a foreign tax on the income from the disregarded transaction.

Generally, the safe harbor in the regulations governing the allocation of CFTEs incurred by a partnership respect allocations of CFTEs that are proportionate to the net income allocated from the activity that incurred the foreign tax.[4] In the case of CFTEs imposed on a disregarded inter-branch payment, there is no directly corresponding item of U.S. taxable income. However, a special rule in the safe harbor in the regulations would respect an allocation of CFTEs that is in proportion to allocations of net income from the payee branch on which the foreign tax is imposed. The reference in the Notice to allocations described in Treasury regulation section 1.704-1(b)(4)(viii)(*d*)(*3*), and certain public comments by Treasury officials,[5] suggest that Treasury and the Internal Revenue Service ("IRS") are concerned that an allocation of CFTEs under this safe harbor (discussed in Part III.B below) that arise from such a disregarded inter-branch transaction may result in a potential foreign tax credit splitting event under section 909. Similar concerns may arguably also arise in situations in which 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.

Part II of the report contains an executive summary of our recommendations. Part III of the report summarizes the existing rules under section 704 for allocating CFTEs. Part IV of the report describes section 909 and its potential application to partnership arrangements. Both sections 704 and 909, as discussed below, apply a regime that generally requires matching of foreign tax expense with income. Using specific examples, Part IV.D of the report analyzes how the safe harbor in the current section 704 regulations may reach results that arguably depart from the matching required by section 909 in three situations: (1) disregarded inter-branch payments, (2) guaranteed payments (under section 707(c)) or allocations of gross income and (3)

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4 The regulations address only taxes imposed on a partnership (*i.e.*, taxes for which the partnership entity, rather than its partners, is legally liable). Taxes for which partners themselves are legally liable are not CFTEs. *See* Treas. Reg. § 1.704-1(b)(4)(viii)(*b*).

5 *See, e.g.*, Lee A. Sheppard, *IRS Discusses Foreign Tax Credit Splitter Notice*, 129 Tax Notes 1166 (Dec. 13, 2010).

allocations under section 704(c)(1)(A) (or the principles thereof) in respect of built-in gain or loss property. Part V of the report recommends certain specific revisions to the current regulations, and Part VI proposes effective dates and transition rules for the revised regulations.

II. Executive Summary

We support the general approach of the current section 704 regulations, which effectively require CFTEs 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 CFTEs based on the partners' interests in the partnership). We believe the "matching" required by the section 704(b) regulations reaches appropriate policy results in most situations, and we generally support the use of safe harbors where possible to simplify the task of "tracing" foreign taxes to particular items in the tax base, which is difficult, burdensome and may create uncertainty for both taxpayers and the government. There are, however, a few situations in which the current section 704(b) rules may permit separation of foreign taxes from the associated income, which allows taxpayers to manipulate effective foreign tax rates in a manner that implicates the policy concerns behind section 909.

Recommendation 1. For reasons explained in the report, we believe potential abuse is most likely to occur in the case of disregarded inter-branch payments by partnerships that have related partners. We therefore recommend that, at a minimum, the section 704(b) regulations be revised to address this particular situation. While the separation of taxes from related earnings can also occur as a result of disregarded inter-branch payments even when the partners are not related, for reasons explained in the report, we do not believe that this situation is likely to occur, and, in addition, do not believe that section 909 is technically applicable in cases involving unrelated partners. As described below, however, the safe harbor rule for disregarded inter-branch payments is uneconomic for unrelated partners and unlikely to be relied upon by unrelated partners for commercial reasons. Accordingly, consideration should be given to simply eliminating the rule for disregarded inter-branch payments. In that case, we suggest that the regulations instead require all partners to apply the "tracing" allocations illustrated by Example 24(iv) of the regulations to CFTEs imposed on disregarded inter-branch payments. We believe this, in contrast to the safe harbor rule, is the allocation scheme most consistent with the arrangements likely to be entered into by unrelated partners acting at arm's length. If the special rule for disregarded inter-branch payments is eliminated, we recommend that the current regulations be revised to expressly state that an allocation of CFTEs that satisfies section 704(b) will satisfy section 909. If the rule for disregarded inter-branch payments is retained, the regulations should instead provide that the fact that an allocation satisfies section 704(b) does not preclude the application of section 909 and include an example involving allocations between related partners under the rule for disregarded inter-branch payments to illustrate the application of section 909 in that case (illustrating that the allocations in Example 24(ii) are an FTC Splitting Event while those in Example 24(iv) are not). However, we do not believe section 909(a) generally should be applied to suspend foreign tax credits when the separation of CFTEs from related income arises from allocations involving disregarded inter-branch payments between unrelated partners. Situations involving allocations between unrelated partners are better addressed directly by the CFTE allocation rules under section 704(b), than by suspending foreign tax credits under section 909.

Recommendation 2. We believe the treatment under the current regulations of guaranteed payments under section 707(c) and gross income allocations reaches appropriate results from a section 909 perspective and requires no revision.

Recommendation 3. In addition, although inconsistent U.S. and foreign tax law treatment of built-in gain and loss property in certain situations may distort effective foreign tax rates, we do not believe that this generally lends itself to manipulation by taxpayers. Situations of abuse in this context likely can be adequately addressed by existing anti-abuse rules, including under section 704(c).

Recommendation 4. 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 do not believe that Treasury should exercise its regulatory authority to treat partnerships as "covered" persons with respect to partners, or *vice versa*.

Recommendation 5. Finally, assuming that the above recommendations are adopted, the report recommends that revised regulations generally should apply to taxable years beginning after 2010 rather than prospectively from the date final regulations are issued because taxpayers are already on notice that section 909 may apply to disregarded inter-branch payments by partnerships that have related partners. However, we would suggest that the Treasury and IRS provide transition relief similar to that provided under Treas. Reg. § 1.704-1(b)(2) with respect to the original CFTE regulations.

III. General Overview of Foreign Tax Credit Regime

A. General Rules

The purpose of the foreign tax credit regime is to mitigate the double taxation of foreign source income that would occur if the foreign source income were taxed both by a foreign jurisdiction and by the United States.

The "direct" foreign tax credit allows a U.S. taxpayer to claim a foreign tax credit with respect to foreign income and similar taxes paid or accrued by the taxpayer during the taxable year.[6] U.S. taxpayers may elect to deduct foreign taxes instead of claiming a direct foreign tax credit.[7] The "indirect" foreign tax credit allows a domestic corporation to claim a foreign tax credit with respect to dividend distributions (or certain other income inclusions) received from foreign corporations in which it owns 10 percent or more of the voting stock (a "first-tier subsidiary") and certain lower tier subsidiaries of such a first-tier subsidiary (together with first-tier subsidiaries, "Section 902 corporations") to the extent these earnings are deemed to have borne creditable foreign taxes.[8]

The amount of foreign taxes that may be credited against a taxpayer's U.S. tax liability is limited by the amount of U.S. tax attributable to foreign source net income, with separate limitations for passive category income, general category income or treaty-resourced income under the rules of section 904(d). For each such limitation category, or "basket," the foreign tax credits that may be claimed cannot exceed the same proportion of the overall U.S. tax liability

6 Section 901(a) and (b).

7 Sections 901(a) and 164(a)(3).

8 Section 902(a) and (b); Treas. Reg. § 1.902-1(a)(4)(ii).

(determined without any foreign tax credits) that the amount of foreign source income in the relevant basket bears to the U.S. taxpayer's worldwide income in that basket. For the purpose of calculating the foreign tax credit limitation within each basket, foreign income and the associated foreign tax is effectively averaged across jurisdictions, and across different transactions that generate the relevant class of income.[9] Accordingly, the rules permit cross-crediting and averaging of foreign taxes within baskets to a significant extent.

In the case of partnerships, corporate partners, individual limited partners that own a 10% or greater interest in a partnership, and individual general partners determine the section 904 basket to which their distributive shares of partnership income are attributable on a look-through basis.[10] Other partners treat partnership income as allocable to the passive basket, with some exceptions.[11]

For purposes of determining entitlement to the foreign tax credit, a foreign tax is treated as paid or accrued by the U.S. taxpayer or Section 902 corporation that is legally liable for the foreign tax under foreign law.[12] Because partnerships are not taxpayers for federal income tax purposes, the partners' entitlement to credits for foreign taxes for which a partnership is legally liable must be determined under the rules governing partnership allocations under section 704. Each partner in a partnership must take into account the partner's distributive share of the foreign taxes paid or accrued by the partnership.[13] Special rules, summarized in more detail below,

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9 Section 904(c). A U.S. taxpayer is in an "excess limitation" position for any category for which its creditable foreign income taxes are less than this maximum amount. A U.S. taxpayer is in an "excess credit" position for any category for which its creditable foreign income taxes exceed this limitation.

10 *See generally* Treas. Reg. § 1.904-5(h).

11 Treas. Reg. § 1.904-5(h)(2).

12 This rule, commonly known as the "technical taxpayer rule," was first enunciated in *Biddle vs. Commissioner*, 302 U.S. 573 (1938), and is currently reflected in Treasury regulation section 1.901-2(f)(1). A detailed discussion of the "technical taxpayer rule" and its role in separating foreign taxes and related income is provided in New York State Bar Association Tax Section *Report on Issues Under Section 909 of the Code* (Report No. 1223, Nov. 8, 2010) (the "Section 909 Report"), *available at* http://www.nysba.org and New York State Bar Association Tax Section *Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons* (Report No. 1083, Apr. 4, 2005) (the "2005 Splitter Report"), *available at* http://www.nysba.org.

13 Section 702(a)(6) and Treas. Reg. § 1.702-1(a)(6). Under Section 902, indirect credits available to a corporate partner through its interest in a partnership are recognized directly by the partner, rather than recognized by the partnership and allocated pursuant to the partnership agreement, and a partner's entitlement to indirect credits therefore is not governed by section 704(b). Therefore, although corporate partners in a partnership that owns a foreign corporation may be entitled to claim, treating the partnership as an aggregate in measuring applicable thresholds, an indirect foreign tax credit for taxes paid by the foreign corporation (with some uncertainty about the treatment of limited partners and foreign partnerships), that credit is not subject to the CFTE Regulations. *See* Rev.

determine how the creditable foreign taxes incurred by a partnership may be allocated for purposes of section 704(b).

B. Overview of Partnership Allocation Rules for Foreign Tax Credits

Treasury regulation section 1.704-1(b)(4)(viii) (the "CFTE Regulations") treats an allocation of CFTEs as incapable of having substantial economic effect. The preamble to the final regulations explains this treatment, stating that "while allocations of CFTEs that are disproportionate to the related income may have economic effect in that they reduce the recipient partner's capital account and affect the amount the recipient partner is entitled to receive on liquidation, this effect will almost certainly not be substantial after taking U.S. tax consequences into account."[14] Thus, rather than focusing narrowly on which partner bears the cost of a foreign tax expense from a capital account perspective, the CFTE Regulations require CFTEs to be allocated in accordance with the partners' interests in the partnership ("PIP").[15] However, CFTE allocations are *deemed* to be in accordance with PIP (*i.e.*, to be within a "Deemed PIP Safe Harbor") if (1) the CFTE is allocated in proportion to the distributive share of partnership income to which the CFTE relates (the "Proportionate to Income" rule) and (2) all other allocations of partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to a partner under the Proportionate to Income rule are valid.[16]

The Deemed PIP Safe Harbor provides a detailed method to determine the income to which a CFTE "relates" for this purpose. The regime computes net income and allocates it to "CFTE categories," then allocates and apportions CFTEs to the CFTE categories to which the related income has been allocated. A CFTE category is any activity of the partnership if the allocation of net income or loss from the activity differs from the allocation of net income and loss from other activities.[17] Thus, a distinct activity of the partnership generally is a separate

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Rul. 71-141, 1971-1 C.B. 211; INTL-933-86, 1995-1 C.B. 959. For that reason, the balance of the Report focuses on the direct credit.

14 T.D. 9292, 71 F.R. 61648-61662 (Oct. 19, 2006). Thus, an underlying premise of the regulations is that a dollar of foreign tax expense reflected in a capital account reduction would generally be offset by an economically offsetting reduction in U.S. taxes, albeit not reflected in capital accounts, that would neutralize the economic effect of the allocation. The CFTE Regulations were drafted based on the assumption that a partner allocated a CFTE would claim a credit even though "in rare instances" the partner may choose to deduct the CFTE. *Id.*

15 *See* Treas. Reg. § 1.704-1(b)(4)(ii).

16 Treas. Reg. § 1.704-1(b)(4)(viii)*(a)*.

17 Treas. Reg. § 1.704-1(b)(4)(viii)*(c)(2)(i)*.

category if there are differential allocations of items from that activity compared with the allocations of items from one or more of the partnership's other activities. The segregation of the partnership business into separate activities is factual, and the effect of separating CFTEs from foreign income is a principal consideration in assessing whether a partnership's aggregation or disaggregation of income into categories is reasonable.

The net income attributable to a CFTE category is determined by taking into account all partnership items attributable to the activity grouping (allocating items of expense for this purpose under the principles of Treasury regulation sections 1.861-8 and 1.861-8T, but using any reasonable method for interest expense).[18] Importantly, net income in a CFTE category is the net income determined under U.S. federal income tax principles. The regulations expressly provide that, for purposes of determining net income attributable to activity conducted by a branch, only items of gross income that are recognized by the branch for U.S. federal income tax purposes are taken into account.[19] To determine the partners' distributive shares of net income from the CFTE category, the rules measure the aggregate net income allocated to each partner from that category, treating guaranteed payments or gross income allocations that are not deductible under foreign law as a distributive share of the net income.[20] Thus, a partner's distributive share for this purpose is the income allocable to that partner from the CFTE category as a percentage of all income in that CFTE category; it is not necessarily the stated residual percentage allocation.

Having determined the various CFTE categories and the net income (determined under U.S. federal income tax principles) in each category, CFTEs are then associated with a CFTE category (under principles similar to Treasury regulation section 1.904-6) based on whether the income in a category was included in the base upon which the foreign tax was imposed.[21] Obviously, matching foreign tax expense to U.S. taxable income using the general foreign base inclusion principle is problematic when the foreign tax is imposed on an item that is not recognized for U.S. federal income tax purposes as there will be no income item in the U.S.

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[18] Treas. Reg. § 1.704-1(b)(4)(viii)*(c)(3)(i)*.

[19] Treas. Reg. § 1.704-1(b)(4)(viii)*(c)(3)(i)*.

[20] Treas. Reg. § 1.704-1(b)(4)(viii)*(c)(3)(ii)*.

[21] Treas. Reg. § 1.704-1(b)(4)(viii)*(d)(1)*.

income tax base with which the CFTE can be directly linked.[22] Accordingly, the regulations provide special rules to deal with inconsistencies between the U.S. and the relevant foreign tax bases.

A foreign tax imposed on an item that would be income under U.S. principles in a different taxable year (*i.e.*, a timing difference) is allocated to the CFTE category in which the income would be included if it were recognized in the year the tax is imposed.[23] A foreign tax imposed on an item that is not, and will never be, income under U.S. federal income tax principles (*i.e.*, a base difference)[24] is allocated to the CFTE category that includes the items attributable to the activity with respect to which the foreign tax is imposed.[25] Under a special rule for inter-branch payments (including a payment between the partnership and one of its branches), foreign tax imposed on income recognized by a foreign country with respect to the inter-branch payment is allocated to the CFTE category that includes the items from the recipient branch's relevant activities (the "Disregarded Branch Payment" rule) even though that income is not recognized for U.S. tax purposes and therefore is not included in the U.S. tax base upon which the CFTE was imposed.[26] Partnerships that choose not to rely on the Disregarded Branch Payment rule are permitted to trace the CFTEs to related income under the general PIP standard if they are able to substantiate adequately the relationship between the income and CFTEs.[27]

These rules are intended to provide administrable bright-line standards that minimize the burden on taxpayers when they must "trace" CFTEs to an item of income that is recognized for U.S. federal income tax purposes and that bears an indirect relationship to the foreign tax. The current regulations therefore represent a trade-off between the desire to relate the foreign tax to income recognized under U.S. tax principles and administrability considerations. In explaining

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[22] The same problem arises under Treasury regulation section 1.904-6 generally. Under section 904, for taxable years beginning after 2006, base difference items generally are simply allocated to the passive income category by default. *See* section 904(d)(2)(H).

[23] Treas. Reg. § 1.704-1(b)(4)(viii)*(d)(2)*.

[24] To avoid issues about whether particular inconsistencies in tax bases represent true "base differences," the report will refer generically to base inconsistencies that are not obviously mere timing differences resulting from different accounting methods as "base disparities."

[25] Treas. Reg. § 1.704-1(b)(4)(viii)*(d)(2)*.

[26] Treas. Reg. § 1.704-1(b)(4)(viii)*(d)(3)*.

[27] *See* Treas. Reg. § 1.704-1(b)(5), Ex. 24(iii) and (iv).

the safe harbors adopted for timing and base differences, including inter-branch payments, the preamble to the final CFTE Regulations acknowledges that

> [i]t is possible that this approach might result in distortions of the effective foreign tax rates on the partners' distributive shares of income in certain cases. Nevertheless, the IRS and the Treasury Department have concluded that imposing a requirement to trace taxes imposed on the recipient with respect to such inter-branch payments to income recognized under U.S. tax principles by the payor would be difficult for taxpayers to comply with and for the IRS to administer.[28]

Our prior reports have supported the general conceptual approach that was adopted in the CFTE Regulations of allocating foreign tax credits based on the allocation of associated income and of adopting, where possible, administrable rules that avoid the complexity of "tracing" taxes to income determined under foreign tax principles or applying the amorphous PIP standard.[29]

IV. Section 909 Issues with Partnership Allocations of CFTEs

A. Overview of Section 909

Section 909 imposes a deferral or "matching" regime for foreign income taxes paid or accrued by a U.S. taxpayer and the related foreign income if there is a "foreign tax credit splitting event" (an "FTC Splitting Event")[30] An FTC Splitting Event with respect to any portion of any foreign income tax paid or accrued by the relevant person (*i.e.*, the "payor") occurs if the foreign income to which such taxes relate is taken into account under U.S. tax principles by a "covered person."[31] A person is a covered person for this purpose if the payor (1) holds, directly or indirectly, at least a 10 percent interest (by vote or value) in such person, (2) is at least 10 percent (by vote or value) directly or indirectly owned by such person, (3) is related to such

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28 T.D. 9292, 71 F.R. 61648-61662 (Oct. 19, 2006).

29 *See* New York State Bar Association Tax Section *Report on Temporary and Proposed Regulations Concerning Allocation of Creditable Foreign Tax Expenditures* (Report No. 1069, Sept. 30, 2004) (the "2004 CFTE Allocation Report"), *available at* http://www.nysba.org. *See also* the 2005 Splitter Report and the Section 909 Report.

30 Section 909(a) and (b). "Foreign income tax" is defined in the same manner as under section 901 and includes tax paid in lieu of a foreign income tax, as defined under Section 903. Section 909(d)(2). *See* Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 5893, the "Investing in American Jobs and Closing Tax Loopholes Act of 2010,"* (JCX-39-10), July 29, 2010, at 21 (the "JCT Report").

31 Section 909(d)(1) and (3). Importantly, the definition of FTC Splitting Event includes the requirement that a covered person must take into account the related income. It is not sufficient that a taxpayer who pays or accrues a foreign tax does not include a corresponding amount of income.

person under section 267(b) or section 707(b), or (4) any other person specified by the Secretary.[32]

For direct foreign tax credit purposes, section 909 provides that the foreign income tax subject to the FTC Splitting Event may be taken into account (*i.e.*, credited subject to the limitations described above) no earlier than the taxable year in which the taxpayer takes the related income into account.[33]

B. <u>Treatment of Partnerships — General Rules</u>

Section 909 provides limited guidance on partnerships. Section 909(c)(1) states that in the case of a partnership, sections 909(a) and (b) are to be applied at the partner level, strongly suggesting an aggregate approach applies. In applying the FTC Splitting Event test to partnerships, however, it is necessary to decide how the "covered person" definition should apply (*i.e.*, whether the partners between whom foreign tax credit and related income is "split" need be related to each other, to the partnership, to both or, as the Notice perhaps implies, to neither).[34]

Although section 909(c)(1) does not expressly reference the "covered person" definition, for reasons below we do not think that, solely for this purpose, an entity approach should apply to treat partnerships as "taxpayers" and partners that are related to the partnership, but not to another partner, as "covered persons." Treasury and the IRS have express regulatory authority to define as "covered persons" persons who do not bear any of the relationships to each other specified in section 909(d).[35] Consequently, that authority could be employed to treat each partner as a covered person with respect to every other partner in the same partnership. Despite the broad grant of authority in section 909(d)(4)(D). Congress appears to have intended a more

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32 Section 909(d)(4).

33 Sections 909(a) and (c)(2). The U.S. dollar amount of the foreign income taxes paid or accrued continues to be determined under section 986(a) by reference to exchange rates in the taxable year in which the foreign income tax is actually paid or accrued. For purposes of determining the carryback and carryforward period of excess foreign tax credits under section 904(c), the deduction under section 164(a) and the extended period for claim of a credit or refund under section 6511(d)(3)(A), the foreign income taxes are treated as paid or accrued in the taxable year in which the related foreign income is taken into account. *See* the JCT Report at 20.

34 *See* Notice ("... to the extent such allocations result in foreign income taxes being allocated to a different partner than the related income.").

35 Section 909(d)(4)(D).

limited use of this authority to attack specific abuse cases.[36] It therefore does not make sense for the government to exercise its regulatory authority in that manner for partnerships unless there is significant potential for abuse peculiar to transactions involving unrelated partners that does not arise in other FTC Splitting Event contexts. We do not believe that to be the case, as explained below. Treating unrelated partners as covered persons who have engaged in an FTC Splitting Event also effectively operates in most cases as a permanent disallowance of the foreign tax credits that are generated by inter-branch transactions as the "taxpayer" partner will never include the related income. In this regard, while not dispositive, the heading of section 909 "Suspension of Taxes and Credits until Related Income Taken into Account" suggests that permanent disallowance is not what Congress intended.[37]

In light of the general aggregate approach mandated by section 909(c)(1), the sensible reading of section 909 in the partnership context is to treat "taxpayer" and "payor" as synonymous (on the basis that, with respect to CFTEs, only partners, and not partnerships, are taxpayers from a U.S. tax perspective) and test whether the partner allocated the foreign tax expense is related to the partner that includes the "related" income.[38] That appears to be the approach implicitly adopted by the Notice.[39]

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[36] The JCT Report provides that Treasury may issue regulations "that treat an unrelated counterparty as a covered person in certain sale-repurchase transactions and certain other transactions deemed abusive." The JCT Report at 21.

[37] We note that other statutory provisions that employ comparable language also adopt an aggregate approach and test at the partner level. For example, in the anti-churning rules under section 197, section 197(f)(9)(E) states that "determinations under this paragraph shall be made at the partner level . . . ." Following this statutory language, the regulations implementing the anti-churning rules adopt an aggregate approach and do not attempt to apply an aggregate approach for some purposes and an entity approach for other purposes. *See* Treas. Reg. § 1.197-2(h)(12).

[38] There is a strained technical interpretation under which section 909 could apply even if the partner that is allocated foreign tax expense is unrelated to the partner to whom the related income is allocated, provided that partner is related to the partnership. The "covered person" definition, which is in section 909(d), is not directly cross-referenced by the mandate to apply sections 909(a) and (b) at the partner level and therefore arguably could be applied treating the partnership entity as the "payor." However, such an interpretation leads to peculiar results because under this reading every 10 percent or greater partner would be a covered person as to the "payor" (*i.e.*, the partnership) even if that partner is also the "taxpayer" for purposes of the operative rule in section 909(a), and an FTC Splitting Event would occur as to any 10% or greater partner that is allocated both the foreign tax and the related income (although presumably in that instance the credit would become available immediately because the taxpayer has included the related income). Further, it is difficult to understand as a policy matter why there should be a distinction between partners allocated foreign taxes who own 10% or more of the partnership (*i.e.*, would be related to the partnership) and those who own 9.9% (and would not be related to the partnership payor) but might be closely related to another partner to whom related income may be allocated. To prevent potential abuse, one would have to read the "covered person" definition to mean partners who are related either to the partnership (as direct payor of the foreign tax) or the other partner who "accrues" the foreign tax for purposes of the foreign tax credit

C. <u>Approach to Relating Income to Taxes</u>

The statute contains no specific guidance on circumstances in which income and foreign tax expense allocated from a partnership should be treated as "separated" for section 909 purposes. Accordingly, this must be divined from the general approach to relating taxes to income under section 909.

As discussed above, the Deemed PIP Safe Harbor treats foreign taxes as "related" to income first by categorizing income recognized for U.S. purposes and then attributing taxes to that income to the extent that income is reflected in the tax base of the foreign taxing country. Where that is not possible because there is no U.S. taxable income to which the income in the foreign tax base directly corresponds, the taxes are related to the activity that gave rise to the foreign tax base income item or, in the case of inter-branch items, attributed to the recipient branch.[40] The foreign taxes are then allocated in proportion to allocations of U.S. taxable income in the relevant CFTE category.

The extent to which this Proportionate to Income approach under the Deemed PIP Safe Harbor diverges from the section 909 approach to relating income to foreign taxes is not clear. Section 909(d)(3) provides that the term "related income" means, with respect to any portion of any foreign income tax, the income (or, as appropriate, earnings and profits) to which such portion of the foreign income tax relates. The JCT Report states that "[t]he provision adopts a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income."[41] The summary then provides that "'related income' means, with respect to any

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rules, which is very difficult to reconcile with the plain statutory language. We therefore do not believe this is what Congress intended by section 909(c)(1).

39 The Notice effectively treats a partner for pre-2011 years as if it paid or accrued directly taxes paid or accrued by the partnership that are allocable to such partner. *See* Notice § 5.01. *Cf.* Notice § 5.02 ("[f]or purposes of applying section 909 in post-2010 taxable years, there will not be a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a partner with respect to its distributive share of the related income of a partnership that is a covered person with respect to the partner to the extent the related income is taken into account by the partner.")

40 Treas. Reg. § 1.704-1(b)(4)(viii)*(d)(2-3).*

41 The JCT Report at 20.

portion of any foreign income tax, the income (or, as appropriate, earnings and profits), *calculated under U.S. tax principles*, to which such portion of foreign income tax relates."[42]

It seems clear that the statute requires foreign taxes to be matched to foreign source income that is recognized for U.S. federal income tax purposes on some basis. However, the statute and this legislative history offer no clear principles to determine how this matching is to be achieved or how attenuated the relationship between the foreign tax and the income item recognized by the U.S. tax system can be. Nor is any clear direction provided on how to relate income to foreign tax when the foreign tax base and U.S. tax base do not coincide. Nothing in the statute or legislative history directly suggests that the approach of the Deemed PIP Safe Harbor to relating income to foreign taxes (and the implicit trade off between theoretical perfection and administrative considerations therein) is generally incorrect or inappropriate. Indeed, we believe the Deemed PIP Safe Harbor generally achieves appropriate results as a policy matter by matching CFTEs to taxable income, although minor revisions may be warranted to deal with the specific issues discussed below.

The statute and legislative history also do not specifically address disregarded inter-branch payments. The grant of regulatory authority does, however, authorize the Secretary to provide appropriate exceptions to the application of section 909, as well as to provide guidance as to how the provision applies in the case of any FTC Splitting Event involving a hybrid instrument. The legislative history anticipates that the Secretary may provide guidance "as to *the proper application of the provision in cases involving disregarded payments*, group relief, or other arrangements having a similar effect."[43]

Circumstantial evidence of what Congress might have intended with regard to base disparities in the partnership context may be gleaned from examples in the legislative history, in particular one example of an FTC Splitting Event resulting from a hybrid instrument ("<u>Example 1</u>"):

> U.S. Corp., a domestic corporation, wholly owns CFC1, a country A corporation. CFC1, in turn, wholly owns CFC2, also a country A corporation. CFC2 is

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[42] *Id.* at 21 (emphasis added).

[43] *Id.* at 22 (emphasis added).

> engaged in an active business that generates $100 of income. CFC2 issues a hybrid instrument to CFC1. This instrument 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 earnings and profits (the accrued interest is ignored since the United States views the hybrid instrument as equity), while CFC1 has paid $30 of foreign taxes. Under the provision, the related income with respect to the $30 of foreign taxes paid by CFC1 is the $100 of earnings and profits of CFC2.

While the potential distortion of the effective foreign tax rates on CFC1 and CFC2, *per se* may be a policy concern, the concern is heightened when the taxpayer can achieve that result as well as control the time at which it repatriates earnings from the CFC1 earnings pool versus the CFC2 earnings pool. By accelerating the repatriation of income from a high-tax pool while deferring repatriation of income from a low tax pool, the current effective foreign tax rate (from a U.S. perspective) on the income recognized by U.S. Corp. in the relevant section 904 limitation category can be manipulated. In practice, taxpayers that engage in such planning generally repatriate the CFC1 earnings (and foreign tax credits), while treating the earnings of CFC2 as permanently reinvested for financial reporting purposes under ASC 740-30, resulting in a permanent benefit for financial statement purposes.

D. Interaction of Sections 704 and 909 — Specific Examples

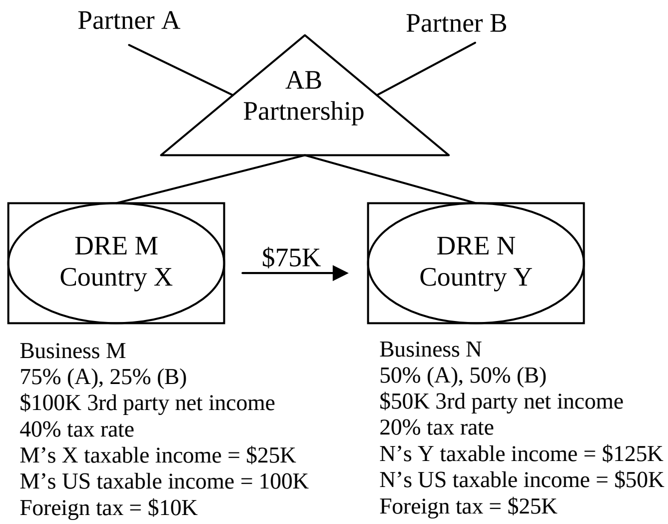
Discussed below are some concrete examples of situations in which partnership arrangements involving foreign taxes may implicate section 909:

1. Disregarded Inter-branch Payments

Example 2 below illustrates the Disregarded Branch Payment rule under the current CFTE Regulations and is based on Example 24 of the regulations.[44]

[44] Treas. Reg. § 1.704-1(b)(5), Ex. 24(i).

a. Example 2



A and B form AB, an eligible entity classified as a partnership for U.S. tax purposes. AB operates business M in Country X and business N in Country Y. Businesses M and N are conducted by entities (DRE M and DRE N, respectively) that are corporations for Country X and Y tax purposes and disregarded entities for U.S. purposes. Country X imposes a 40 percent tax on business M income, Country Y imposes a 20 percent tax on business N income, and the Country X and Country Y taxes imposed are CFTEs. AB has $100,000 of ordinary course income from business M and $50,000 of ordinary course income from business N. DRE M makes payments of $75,000 to DRE N that are deductible by DRE M for Country X tax purposes and includible in income of DRE N for Country Y tax purposes. As a result of those payments, DRE M has taxable income of $25,000 for Country X purposes on which $10,000 of taxes are imposed and DRE N has taxable income of $125,000 for Country Y purposes on which $25,000 of taxes are imposed. For U.S. tax purposes, $100,000 of AB's income is attributable to the activities of DRE M and $50,000 of AB's income is attributable to the activities of DRE N.

(i) *Example 2A* – Proportionate to Income (Based on Ex. 24(ii))[45]

Partnership Agreement Allocations. Assume first that, pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 75 percent to A and 25 percent to B, and all partnership items, including CFTEs, from business N are split equally between A and B. Accordingly, A is allocated 75 percent of the income from business M ($75,000), 75 percent of the Country X taxes ($7,500), 50 percent of the income from business N ($25,000), and 50 percent of the Country Y taxes ($12,500). B is allocated 25 percent of the income from business M ($25,000), 25 percent of the Country X taxes ($2,500), 50 percent of the income from business N ($25,000), and 50 percent of the Country

[45] Treas. Reg. § 1.704-1(b)(5), Ex. 24(ii).

Y taxes ($12,500). Thus, A is allocated $100,000 of the aggregate AB income (66.66%) and is allocated $20,000 of aggregate CFTEs (57.14%). B is allocated $50,000 of aggregate income (33.33%) and $15,000 of CFTEs (42.86%).

Current treatment. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each of business M and business N is income in separate CFTE categories. The $100,000 of net income attributable to business M is in the business M CFTE category and the $50,000 of net income attributable to business N is in the business N CFTE category. The $10,000 of Country X taxes is allocated to the business M CFTE category and the $10,000 of Country Y taxes is allocated to the business N CFTE category. The additional $15,000 of Country Y tax imposed with respect to the inter-branch payment is assigned, under the Disregarded Branch Payment rule, to the business N CFTE category (*i.e.*, the recipient branch). Because AB's partnership agreement allocates the $10,000 of Country X taxes in the same proportion as the distributive shares of income to which the taxes relate and the $25,000 of Country Y taxes in the same proportion as the distributive shares of income (determined under U.S. tax principles) to which the taxes relate, AB satisfies the Deemed PIP Safe Harbor and the allocations of the Country X and Country Y taxes are deemed to be in accordance with the partners' interests in the partnership.

(ii) *Example 2B* – PIP – Special Allocation of Tax Expense (Based on Ex. 24(iii))[46]

Partnership Agreement Allocations. Now assume the partnership agreement provides that the $15,000 of Country Y taxes imposed with respect to the inter-branch payment is allocated 75 percent to A ($11,250) and 25 percent to B ($3,750) and that the remaining $10,000 of Country Y taxes is allocated 50 percent to A ($5,000) and 50 percent to B ($5,000).

Current treatment. The allocations of the Country Y taxes are not deemed to be in accordance with the partners' interests because they are not in proportion to the allocations of the distributive shares of income from the business N CFTE category. However, upon sufficient substantiation that $15,000 of Country Y taxes paid by DRE N with respect to the $75,000 inter-branch payment relates to income that is recognized by DRE M for U.S. tax purposes, the allocations of the Country Y taxes may be established to be actually in accordance with the partners' interests in the partnership. The allocations of the $10,000 of Country X taxes are deemed to be in accordance with the partners' interests in the partnership because the Country X taxes are allocated in the same proportion as the distributive shares of business M income to which they relate.

46 Treas. Reg. § 1.704-1(b)(5), Ex. 24(iii).

(iii) *Example 2C* – PIP – Special Allocation of Income (Based on Ex. 24(iv))[47]

Partnership Agreement Allocations. Now, assume that, pursuant to the partnership agreement, partnership items, including CFTEs, from business M generally are allocated 75 percent to A and 25 percent to B, and partnership items, including CFTEs, from business N generally are allocated equally between A and B. However, in order to reflect the $75,000 payment from DRE M to DRE N, the partnership agreement allocates $75,000 of the income attributable to business M equally between A and B (50 percent each). Therefore, the total income attributable to business M is allocated 56.25 percent to A (75 percent of $25,000 plus 50 percent of $75,000) and 43.75 percent to B (25 percent of $25,000 plus 50 percent of $75,000).

Current treatment. The allocation of the Country X taxes (75 percent to A and 25 percent to B) is not deemed to be in accordance with the partners' interests because it is not in proportion to the allocations of the distributive shares of income from the business M CFTE category. However, upon sufficient substantiation that all $10,000 of Country X taxes paid by DRE M relates to the $25,000 of DRE M 's income that is shared in the same 75-25 ratio, the allocations of the Country X taxes may be established to be actually in accordance with the partners' interests in the partnership. The allocations of the $25,000 of Country Y taxes are deemed to be in accordance with the partners' interests in the partnership because the Country Y taxes are allocated in the same proportion as the distributive shares of income to which they relate.

b. Applicability of Section 909

The treatment of disregarded payments under the Proportionate to Income test in Example 2A, from a U.S. tax perspective, results in separation of Country Y taxes from the income that was included in the base upon which the taxes were imposed. For U.S. tax purposes, the income remains in Country X, but the taxes are in Country Y. This results in an enhanced effective foreign tax rate on DRE N's income and the creation of a pool of high-taxed income.[48] For example, without the inter-branch payments, the effective foreign tax rate from a U.S. federal income tax perspective on DRE N's income would have been 20 percent (*i.e.* Country Y aggregate tax of $10,000 divided by DRE N's U.S. federal taxable income of $50,000). The disregarded inter-branch payment increases the numerator by the incremental Country Y taxes of $15,000 but does not affect the denominator (*i.e.*, the U.S. federal taxable income of DRE N),

47 Treas. Reg. § 1.704-1(b)(5), Ex. 24(iv).

48 The actual example does not have this effect, but that is because of the coincidence of the relative sharing ratios and tax rates as discussed below.

thus increasing the effective foreign tax rate on income from DRE N to 50 percent (*i.e.*, $25,000/ $50,000).[49]

The use of the Disregarded Branch Payment rule to separate CFTEs from income and create high-tax pools of foreign income can be exploited, particularly by partners that are related to each other. For example, assume that a common parent ("USP") owns 100 percent of both partner A and partner B in Example 2. The USP group arguably will be largely indifferent about the location of the income related to DRE N's incremental Country Y tax, because, as an economic matter, the income remains within the same economic family. By taking advantage of the Proportionate to Income rule, the USP group can use inter-branch payments to shift CFTEs to partner B. If A and B are controlled foreign corporations, the group can repatriate income from B (which has the high-taxed income pool) while deferring repatriation of income (including the related income) from A. Alternatively, even if the partners are not controlled foreign corporations and are not members of the same consolidated group, B may be a U.S. taxpayer in an excess limitation position, and A may be a related person that is in an excess credit position, allowing the partners to shift the CFTEs to the partner who can better use the associated foreign tax credit. Accordingly, related partners can use the Disregarded Branch Payment rule to achieve the kind of separation of income from tax that implicates section 909.[50]

Inter-branch transactions are not necessarily motivated by U.S. tax planning considerations and may not implicate the foreign tax credit concerns underlying section 909 even if they achieve a "separation" of income and CFTEs in some sense. For example, assume that DRE M is the Country X sales branch of the Partnership AB business (which maintains its own inventory) and DRE N the manufacturing operation in Country Y and the inter-branch payment is a payment of arm's-length purchase price. These inter-company sales are not driven by U.S. tax planning.

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[49] Although the cash associated with the disregarded payment is in DRE N while partner A and partner B include a corresponding amount of income with respect to DRE M rather than DRE N, this is irrelevant because the partnership can repay A and B's capital account balances with cash from either branch. No federal income tax consequences result from using cash derived from one CFTE category to make distributions with respect to income allocated from another category, although the distribution may have foreign country withholding tax implications, which could, in turn, affect the partners' capital accounts.

[50] Even when the partners are not 100% related, overlapping ownership undermines the economic incentives discussed below that deter unrelated partners from misusing the Deemed PIP Safe Harbor.

Moreover, even if the disregarded transaction enhances the effective foreign tax rate of one branch (from a U.S. perspective) by separating the foreign taxes from income in the other branch, this will not necessarily enhance the effective foreign tax rate of any partner in a particular section 904 basket in aggregate to the extent that items from both branches are allocated to the same basket. If the income from the two branches is allocable to the same basket, the net effect on the effective foreign tax rate in that basket (from a U.S. tax perspective) will also reflect the potential reduction in foreign country tax allocated to the partner from the other payor branch (*i.e.*, DRE M in the above example). Unlike the taxpayer in the hybrid instrument example in the JCT Report, partner B in Example 2 cannot defer recognizing income from the payor branch with the reduced effective foreign tax rate (*i.e.*, DRE M). Thus, in Example 2, the net effect on the effective foreign tax rate in partner B's relevant section 904 basket depends on the partners' relative percentage shares of net income in the two branches and their relationship to the relative foreign tax rates in the two foreign countries.[51] Note that, although unlikely in practice, the reduction in the high-tax country branch's tax resulting from the deduction of the inter-branch payment may exceed the increase in low-tax country branch's tax to the point that, despite a disproportionate allocation of CFTEs to one partner, the U.S. fisc may be better off than if there had been no disregarded inter-branch transaction.

It is thus possible that a disregarded inter-branch payment may neither be motivated subjectively by tax planning considerations nor have the objective effect of enhancing the effective foreign tax rate (from a U.S. federal income tax perspective) of one partner's net income in a particular "basket" even though there is a separation of CFTEs from related income.

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[51] If A and B are controlled foreign corporations, their U.S. parent may be able to defer repatriating income from A while accelerating the repatriation of income from B. Relative to the position if there had been no disregarded transaction, the aggregate effective foreign tax rate in B's section 904 "basket" is increased by the increased effective foreign tax rate on DRE N but reduced to some extent (depending on the sharing percentages) by the reduction in the effective foreign tax rate of DRE M resulting from the same disregarded transaction. On the actual facts of Example 2, for example, while DRE N's effective foreign tax rate (from a U.S. tax perspective) is enhanced, the effective foreign tax rate on partner B's aggregate income from the partnership is unchanged. This occurs because, by coincidence in the example, the ratio of the effective foreign tax rates of DRE M relative to DRE N and the ratio of partner B's distributive shares of business M and business N income are such that the net effect on the effective foreign tax rates of income allocated to partner B is zero. Partner B's 25 percent share of the reduction in Country X tax (at a 40 percent rate) resulting from the $75,000 deduction exactly offsets B's 50 percent share of the incremental Country Y tax (at a 20 percent rate) on that amount of income. Indeed, had the sharing percentages been reversed (*i.e.*, partner B's share of business N income were 25 percent and business M income were 50 percent), the $75,000 disregarded payment would actually decrease the effective foreign tax rate on B's aggregate income from the partnership.

There is a potential argument that taxpayers should be able to rely on the Deemed PIP Safe Harbor, even in the related partner situation, if the partnership is engaged in ordinary course transactions like the inter-branch inventory sales above. However, , as discussed above, under the Disregarded Branch Payment rule, such disregarded transactions can have the result that the income (*e.g.*, from inventory sales) is allocated to the partners differently for U.S. tax purposes than the foreign tax on such income. Further, it may be very difficult administratively to distinguish ordinary course business transactions from "financing" transactions.

Revisions to the CFTE Regulations also need to take into account administrative concerns that would arise under alternative regimes (including PIP) that effectively require taxpayers to "trace" CFTEs to underlying income. While the burden resulting from a tracing regime may be manageable by sophisticated taxpayers, it does impose costs on taxpayers that must be weighed against the risk of abuses a tracing regime is intended to prevent. Tracing also may impose costs on the government on audit as an administrative matter.

Moreover, we recognize that there are disregarded inter-branch items that simply cannot be traced to particular U.S. taxable income, such as in so-called "equity transactions." For instance, consider Example 2A and imagine that in some later taxable year, DRE N must distribute cash to permit distributions to the partners of their capital account balances (which reflect the fact that the disregarded transactions results in "related" income allocated 75-25 pursuant to the DRE M distributive share ratio rather than 50-50). A transaction between a partnership and a branch is an inter-branch transaction under the CFTE Regulations. A portion of that cash will be needed to make distributions with respect to the income allocated from DRE M that arguably is "related" to DRE N CFTEs. However, that distribution from DRE N to the partnership is not recognized for U.S. tax purposes. Accordingly, if DRE N must withhold tax on the distribution of what is a dividend for foreign tax purposes there will never be a U.S. taxable income item that corresponds to the dividend, even though in some sense that portion of the cash distribution is related to the prior allocation of DRE M income.

Nevertheless, taking into account all of the foregoing considerations, on balance we believe the use of disregarded inter-branch payments is too easily manipulated by taxpayers in the course of tax planning. Accordingly, at a minimum, in light of the enactment of section 909, related partners should be prevented from taking advantage of the Disregarded Branch Payment rule.[52] When partners are not related to each other, for reasons below, we believe the risk of taxpayer's misuse of the "separation" of income and CFTEs under the Disregarded Branch Payment rule is reduced. Moreover, the statutory language of section 909 does not appear to contemplate that it would apply in the case of allocations among unrelated partners, unless Treasury and the IRS exercise their regulatory authority under the "covered person" definition (which as discussed earlier, we do not recommend.) On the other hand, as explained below, we believe the allocations resulting from disregarded inter-branch payments under the Disregarded Branch Payment rule are simply uneconomic for unrelated partners and therefore will rarely, if ever, be relied upon by unrelated partners as a commercial matter. Accordingly, even if the unrelated partner case is not strictly within the purview of section 909, consideration should be given to simply eliminating the Disregarded Branch Payment rule.

Assume that partners A and B in Example 2 are entirely unrelated. In Example 2A, under the Proportionate to Income allocation scheme, partner B benefits in a tax sense because she is allocated a 50 percent share of $15,000 of additional Country Y tax while including 25 percent rather than the 50 percent of taxable income she would have included had the transaction been regarded. The Deemed PIP Safe Harbor treatment of disregarded inter-branch transactions in Example 2A therefore may seem to allow the other partners to shift foreign tax expense to the partner who can bear this at no net cost (*i.e.*, a U.S. partner in an excess limitation position) and away from a partner that is unable to use the foreign tax credit because, for example, it is in an excess credit position or is not a U.S. taxpayer. However, the separation of income and CFTEs through disregarded transactions has an opportunity cost to the partner whose effective foreign tax rate is enhanced. In Example 2A, for example, partner B foregoes the $18,750 of economic benefit she would have derived as a book income and capital account matter had the transaction been recognized for U.S. tax purposes (*i.e.*, the difference between the 25 percent of $75,000 she actually is allocated from DRE M and the $37,500 she would have been allocated from DRE N had the transaction been regarded). Other things being equal, receiving foreign tax credits of

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[52] Whatever the different sharing ratios and relative foreign tax rates, taxpayers could enter into a disregarded inter-branch transaction that would achieve their desired tax result. Faced with different sharing ratios or relative foreign tax rates than in Example 2A, the partners could simply enter into an alternative disregarded transaction designed to increase foreign taxes incurred by DRE M without recognition of a proportionate amount of income for U.S. federal income tax purposes.

$7,500 (50 percent of $15,000 of incremental CFTEs) generally does not justify forgoing $18,750 of capital account credit (even taking into account that this additional book income would have been taxable). If the partners know that distributions of the positive capital account balances will be deferred for a number of years, however, it is possible that the transaction would be advantageous to partner B, discounting the forgone capital account credit appropriately to reflect time value of money considerations.

If the inter-branch transactions are assumed to be on approximately arm's-length terms and the partners are unrelated to each other, the risk that effective tax rates can be artificially manipulated is limited. Incentives to "trade" foreign tax credits may exist if unrelated partner B is in an excess limitation position and can fully use foreign tax credits to an unlimited extent and partner A is in an excess credit position or is not a U.S. taxpayer, because the credit has a higher value to partner B. However, if capital accounts are maintained based on income measured under U.S. federal income tax principles and the partnership liquidates in accordance with capital accounts, partner B in Example 2 would generally prefer the partnership to engage in an equivalent regarded transaction rather than the disregarded inter-branch transaction. For that reason, unrelated partners acting at arm's-length are unlikely to rely on the Disregarded Branch Payment rule as a commercial matter.

Assume, for example, that the disregarded inter-branch payment of $75,000 represents interest at an arm's-length interest rate and terms on a $1 million loan from DRE N to DRE M. Instead, the partnership could have caused DRE N to lend the available funds to a third party and DRE M to borrow $1 million from a different third party, in each case on the same terms. The local tax effect is no different and therefore the aggregate effect on local tax expense and partner A and partner B's distributive share of CFTEs is identical. What changes is the book income each partner recognizes for capital account purposes. Although partner B would in that case have recognized more taxable income for U.S. purposes, she also would necessarily have been entitled to correspondingly more economic income as a commercial matter (provided the partnership liquidates in accordance with positive capital account balances).

This means that unrelated partners have different incentives regarding disregarded inter-branch payments. Each $1 of taxable income (mis)allocated to one partner (*e.g.*, partner A) for

U.S. federal income tax purposes represents at most a $1 post-tax benefit to that partner (assuming, because of excess credits, that U.S. income tax on the additional foreign source income can be fully offset by available but otherwise unusable credits). Subject to the time value of money considerations mentioned above, the value to the other partner (*e.g.*, partner B) of that partner's share of "related" foreign tax credit will never in absolute terms exceed this amount (and any benefit of an allocation of additional CFTEs is offset because partner B actually economically bears a larger share of the economic cost of the foreign tax payment).

To illustrate, assume facts identical to those in Example 2A, except that Country Y imposes a 30 percent tax on business N income rather than a 20 percent tax. The incremental after-tax results to partner B when $1 of related taxable income is (mis)allocated to partner A as a result of the disregarded inter-branch transaction is illustrated in the following table:

Disregarded inter-branch payment	$ 4.00	**Partner A tax expense and credit**	
		Reduction in DRE M Tax (75% share)	$ (1.20)
Country X tax rate	40%	Increase in DRE N tax (50% share)	$ 0.60
DRE M tax reduction	$ (1.60)	Net change	$ (0.60)
Country Y tax rate	30%	**Partner B tax expense and credit**	
DRE N tax increase	$ 1.20	Reduction in DRE M tax (25% Share)	$ (0.40)
		Increase in DRE N tax (50% share)	$ 0.60
		Net change	$ 0.20
Net book income shifted to partner A		**Net result to partner B of disregarded inter-branch payment**	
= [75% x Additional DRE M Income] – [50% x Foregone DRE N Income]	$ 1.00	— Debit to capital account for incremental tax expense	$ (0.20)
Net book income forgone by partner B		— Value of incremental credit against cash tax liability	$ 0.20
= [25% x additional DRE M income] – [50% x forgone DRE N income]	$ (1.00)	**Net Result to Partner B of disregarded inter-branch payment**	0
After tax opportunity cost to partner A		**After tax opportunity cost to partner B**	
+ Book income increase	$ 1.00	- Book Income forgone	$ (1.00)
- U.S. tax on additional income (after using unrelated excess credits)	0.00	+ U.S. tax avoided on forgone income	$ 0.35
+ Credit to capital account for reduction in tax expense	$ 0.60	- Debit to capital account for incremental tax expense	$ (0.20)
- Loss of additional credits (taking into account excess credit position)	0.00	+ Value of incremental credit against cash tax liability	$ 0.20
After-tax result relative to equivalent regarded transaction	$ 1.60	**After-tax result relative to equivalent regarded transaction**	$ (0.65)

Had the inter-branch payment been recognized for U.S. federal income tax purposes, the allocations of additional taxable income from business N and reduced taxable income from business M would have resulted in an additional $1 being allocated to partner B's capital account. Because the payment is deductible for Country X purposes and includible for Country Y purposes regardless of whether the payment is between entities regarded for U.S. federal income tax purposes, the net effect of the payment will be a $0.20 incremental additional credit to partner B. Although partner B recognizes this incremental credit, partner B also bears the economic cost of the increased Country Y tax expense of $0.20. Thus, the only economic result of the disregarded inter-branch payment is a loss of the $1 of book income that would have been otherwise allocated to partner B had the inter-branch payment been recognized for U.S. federal income tax purposes. Accordingly, absent the time value of money considerations mentioned above, from an *ex post* perspective unrelated partners would not generally agree to such a "trade" of tax for other economic benefits. For the same reason, unrelated partners acting at arm's length are unlikely to rely on the Disregarded Branch Payment Rule as a commercial matter.

Applying the Disregarded Branch Payment rule to partnerships with unrelated partners would raise more serious policy concerns if partners could manipulate how CFTEs are allocated without corresponding commercial consequences. For example, if DRE N could charge DRE M royalties for use of spurious intangible assets or fees for questionable "management" services that, in each case, are difficult to value but were respected for foreign tax purposes, the transaction could artificially "shift" the CFTEs to partner B with limited economic consequences to either partner. However, this assumes the foreign countries will respect off-market arrangements like those above. Most foreign countries that impose material taxes are likely to have transfer pricing regimes that limit the viability of economically off-market arrangements like those above. Further, such arrangements seem very vulnerable to challenge under section 482, which can override section 704(b) by the express terms of the section 704(b) regulations.[53] Accordingly, even if such manipulation is possible, we see it as technically within the purview of anti-abuse provisions, not section 909. Nevertheless, since the Disregarded Branch Payment rule is an uneconomic rule as applied to unrelated partners, we see no compelling reason to retain the Disregarded Branch payment rule in the case of unrelated partners.

[53] Treas. Reg. §§ 1.704-1(b)(1)(iii) and (iv).

2. <u>Guaranteed Payments and Preferential Gross Income Allocations</u>

The Disregarded Branch Payment rule is not the only aspect of the Deemed PIP Safe Harbor that can reach results that arguably constitute a separation of CFTEs from related income. The treatment of guaranteed payments (under section 707(c)) or allocations of gross income and allocations under section 704(c)(1)(A) (or the principles thereof) in respect of built-in gain or loss property raises somewhat similar issues. However, for reasons below, we believe the Deemed PIP Safe Harbor reaches results with respect to those transactions that either should not be considered FTC Splitting Events for purposes of section 909 or, if they arguably could be considered FTC Splitting Events, are far less susceptible to manipulation by taxpayers than disregarded inter-branch transactions and therefore do not implicate the policy concerns underlying section 909 to nearly the same extent.

As discussed above, the CFTE Regulations require partners to take into account a guaranteed payment or preferential allocation of gross income in measuring net income received by the partners from a CFTE category for purposes of the Proportionate to Income test if, but only if, the foreign country does not treat the payment as a deductible expense.[54] Accordingly, in the case of such a payment that is not deductible under foreign law, if the partners allocate CFTEs only by reference to their proportionate shares of residual net income, the allocation does not satisfy the Deemed PIP Safe Harbor. The following examples illustrate the approach of the CFTE Regulations to guaranteed payments and gross income allocations.

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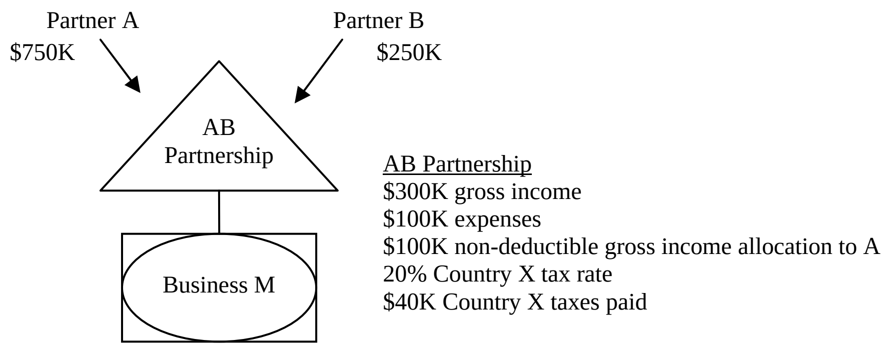
[54] Treas. Reg. § 1.704-1(b)(4)(viii)*(c)(3)(ii)*.

a. Examples

(i) *Example 3A* – Non-Deductible Gross Income Allocation[55]



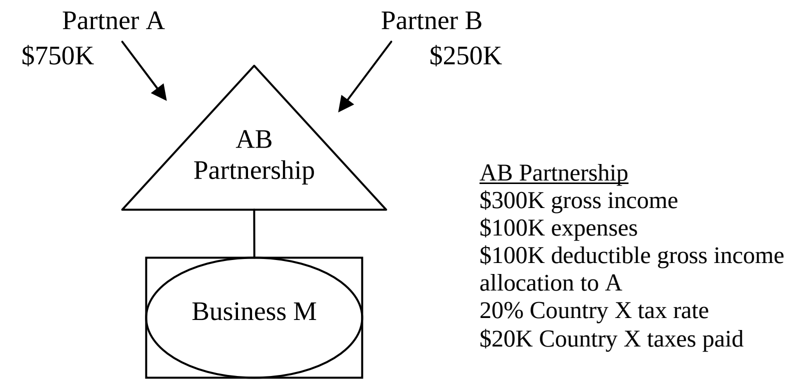
Facts. A contributes $750,000 and B contributes $250,000 to form AB, an eligible entity classified as a partnership for U.S. tax purposes. AB operates business M in Country X. Country X imposes a 20 percent tax on the net income from business M, which tax is a CFTE. AB earns $300,000 of gross income, has deductible expenses of $100,000, and pays or accrues $40,000 of Country X tax. Pursuant to the partnership agreement, the first $100,000 of gross income each year is allocated to A as a return on excess capital contributed by A. All remaining partnership items, including CFTEs, are split evenly between A and B (50 percent each). The gross income allocation is *not* deductible in determining AB's taxable income under Country X law.

Allocations. AB has a single CFTE category because all of AB's net income is allocated in the same ratio. The net income in the single CFTE category is $200,000. The $40,000 of Country X tax is allocated to the single CFTE category and, thus, related to the $200,000 of net income in the single CFTE category. AB's partnership agreement allocates $150,000 or 75 percent of the net income to A ($100,000 attributable to the gross income allocation plus $50,000 of the remaining $100,000 of net income) and $50,000 or 25 percent of the net income to B. AB's partnership agreement allocates the Country X taxes in accordance with the partners' shares of partnership items remaining after the $100,000 gross income allocation. Therefore, AB allocates the Country X taxes 50 percent to A ($20,000) and 50 percent to B ($20,000).

Result. AB's allocations of Country X taxes are not within the Deemed PIP Safe Harbor because they are not in proportion to the allocations of the distributive shares of income to which the Country X taxes relate (treating the non-deductible special allocation of gross income as a distributive share of income). Accordingly, the Country X taxes must be reallocated according to the partners' interests in the partnership.

55 Treas. Reg. § 1.704-1(b)(5), Ex. 25(i-ii).

(ii) *Example 3B* – Deductible Gross Income Allocation[56]



Facts. The facts are the same as above, except that the $100,000 allocation of gross income is deductible under Country X law and AB pays or accrues $20,000 of foreign tax.

Allocations. The net income in the single CFTE category is the $100,000 of net income, determined by disregarding the $100,000 of gross income that is allocated to A and deductible in determining AB's taxable income under the law of Country X. The $20,000 of Country X tax is allocated to the single CFTE category, and thus, related to the $100,000 of net income in the single CFTE category. No portion of the tax is related to the $100,000 of gross income allocated to A. Pursuant to the partnership agreement, AB allocates the Country X taxes 50 percent to A ($10,000) and 50 percent to B ($10,000).

Result. AB's allocations of Country X taxes are deemed to be in accordance with the partners' interests in the partnership.[57]

(iii) *Example 3C* – Foreign Pass-through Treatment

Facts. Assume the same facts as in the example above, except that (1) both Country X and the United States tax the partnership on a pass-through basis and Country X imposes tax directly on the non-Country X partners with respect to their allocable shares of business M income and (2) the $100,000 payment to A is styled as a guaranteed payment for the use of capital. Further, assume Country X does not consider the guaranteed payment a share of net income subject to its tax but a deductible item (akin to payment of interest on a loan from the partner) and also does not impose withholding tax on those payments.

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56 Treas. Reg. § 1.704-1(b)(5), Ex. 25(iii).

57 Note that the Treasury regulations provide that the result described in Example 3 discussed above would not change if the payment to A was a section 707(c) guaranteed payment rather than a gross income allocation. Treas. Reg. § 1.704-1(b)(5), Ex. 25(iv).

> *Result*. This variation is not governed by the CFTE Regulations because there is no foreign tax imposed on the partnership to be allocated.[58] Country X treats A and B as each earning $50,000 (50 percent of $100,000 of net income) and imposes tax directly on each partner of $10,000. From a U.S. federal income tax perspective, A recognizes $150,000 of income and B recognizes $50,000. The economic result to the partners is identical to that in Example 3B.

b. Applicability of Section 909

From a technical perspective, it is reasonable to conclude that the treatment in the current CFTE Regulations of guaranteed payments and gross income allocations does not cause an FTC Splitting Event concern. The section 704(b) regulations implicitly conclude that an item that is income to a partner cannot be considered to "relate" to foreign taxes paid by the partnership when payment of that amount by the partnership to the partner results in a partnership level deduction that actually reduces the foreign taxes paid by the partnership (and, hence, allocable to the partners). That income is not included in the foreign tax base of the country that imposed the creditable tax. Accordingly, the current approach seems appropriate from a technical section 909 perspective.[59]

Adopting a contrary approach would create discontinuities between the treatment of interest on partner loans and guaranteed payments, which have largely equivalent economic consequences.[60] It also would create discontinuities with economically equivalent transactions in which tax liability was technically imposed on partners rather than the partnership. For example, the economic result in Example 3C, above, is identical to that in Example 3B. However, allocation of the foreign tax in Example 3C is not governed by the CFTE Regulations, because

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58 *See* Treas. Reg. § 1.704-1(b)(4)(viii)(*b*).

59 An argument can be made that even deductible guaranteed payments can constitute an FTC Splitting Event. Such payments are part of the capital structure of an entity. As in the case of interest paid to a partner or related party, if no foreign taxes are considered to relate to the payments, then there is the ability to create a separation of entity taxes from entity income by structuring the payments accordingly. While that result is necessary in the case of interest (given that a loan is in no sense an interest in the entity that carries with it a share of underlying taxes), it is not necessary in the case of a guaranteed payment. From the standpoint of the United States, which is granting a credit to alleviate double taxation, it could be argued that it would not be inappropriate to focus on the income derived from alternative forms of capital investment rather than on the foreign law deductibility of the payment.

60 The extent to which the tax results would truly be equivalent is not entirely clear given uncertainties over the source rules for guaranteed payment income and expense. *Cf.* Treas. Reg. § 1.707-1(c); *Miller v. Comm'r*, 52 T.C. 752 (1969).

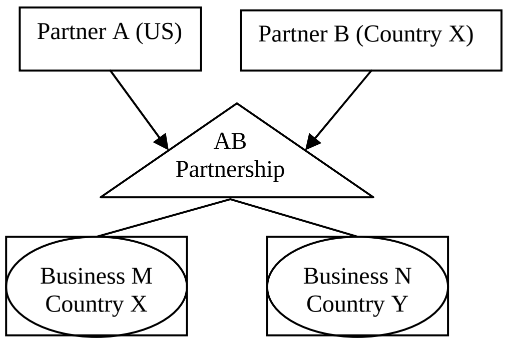
foreign taxes paid or accrued by a partner are not CFTEs.[61] Thus, although partner B includes less than 50 percent of the aggregate income for U.S. federal income tax purposes, partner A and partner B are each the "technical taxpayer" with respect to $10,000 of Country X taxes and the result would not be affected by revisions to the CFTE Regulations. Adopting a different approach to guaranteed payments and gross income allocations in the CFTE Regulations without addressing the operation of the "technical taxpayer" rule in equivalent transactions may merely create incentives to conduct transactions in countries whose tax regime treats the entity as a pass-through entity, but whose allocation scheme does not follow section 704, and that therefore are not within the purview of section 909.

3. Section 704(c)

Section 704(c)(1)(A) also implicates section 909 because it may result in a special allocation of pre-contribution gain for tax purposes to a partner, taken into account under the Proportionate to Income test, that may not correspond to how a foreign country tax system deals with built-in gain or loss property. Under the CFTE Regulations, a special allocation of taxable section 704(c) pre-contribution gain constitutes income for purposes of the Proportionate to Income test. (Other special allocations of income or deduction required under section 704(c) presumably also are appropriately taken into account in measuring income from each CFTE category for purposes of the test.)

[61] *See* Treas. Reg. § 1.704-1(b)(4)(viii)(*b*).

a. *Example 4A* – Core Example[62]



Beginning Balance Sheet

	Assets			Capital Accounts	
	Tax	Book		Tax	Book
Cash	800K	800K	A	50K	200K
Building	50K	200K	B	800K	800K

Business M
20% (A) and 80% (B)
\$250K operating income
\$150K gain on sale of building - allocable to A under 704(c)
20% tax rate
\$80K Country X tax
A's U.S. income = \$200K
A's CFTE = \$40K
B's U.S. income = \$200K
B's CFTE = \$40K

Business N
20% (A) and 80% (B)
\$100K operating income
40% tax rate
\$40K Country Y tax
A's U.S. Income = \$20K
A's CFTE = \$8K
B's U.S. Income = \$80K
B's CFTE = \$32K

Facts. A and B form AB, an eligible entity classified as a partnership for U.S. tax purposes. AB operates business M in Country X and business N in Country Y. A, a U.S. corporation, contributes a building with a fair market value of \$200,000 and an adjusted basis of \$50,000 for both U.S. and Country X purposes. The building contributed by A is used in business M. B, a Country X corporation, contributes \$800,000 cash. The AB partnership agreement provides that AB will make allocations under section 704(c) using the traditional method and that all other items, excluding creditable foreign taxes, will be allocated 20 percent to A and 80 percent to B. The partnership agreement provides that creditable foreign taxes will be allocated in proportion to the partners' distributive shares of net income in each CFTE category, which shall be determined by taking into account items allocated pursuant to section 704(c). Country X and Country Y impose tax at a rate of 20 percent and 40 percent, respectively, and such taxes are CFTEs. In a later year, AB sells the building contributed by A for \$200,000, thereby recognizing taxable income of \$150,000 for U.S. and Country X purposes, and recognizes \$250,000 of other income from the operation of business M. AB pays or accrues \$80,000 of Country X tax on such income. In that same taxable year, business N recognizes \$100,000 of taxable income for U.S. and Country Y purposes and pays or accrues \$40,000 of Country Y tax. Pursuant to the partnership agreement, A is allocated \$200,000 of business M income (\$150,000 of taxable income in accordance with section 704(c) and \$50,000 of other business M income) and \$40,000 of Country X tax, and 20 percent of both business N income (\$20,000) and Country Y tax (\$8,000). B is allocated

[62] Treas. Reg. § 1.704-1(b)(5), Ex. 26(i).

$200,000 of business M income and $40,000 of Country X tax and 80 percent of both the business N income ($80,000) and Country Y tax ($32,000). Assume that allocations of all items other than CFTEs are valid.

Allocations. The net income attributable to business M ($400,000) is allocated 50 percent to A and 50 percent to B while the net income attributable to business N ($100,000) is allocated 20 percent to A and 80 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each activity is income in a separate CFTE category. The net income in the business M CFTE category is the $400,000 of net income attributable to business M, and the net income in the business N CFTE category is the $100,000 of net income attributable to business N. The $80,000 of Country X tax is allocated to the business M CFTE category, and the $40,000 of Country Y tax is allocated to the business N CFTE category. Therefore, the $80,000 of Country X tax relates to the $400,000 of net income in the business M CFTE category, and the $40,000 of Country Y tax relates to the $100,000 of net income in the business N CFTE category.

Result. Because AB's partnership agreement allocates the $80,000 of Country X taxes and $40,000 of Country Y taxes in proportion to the distributive shares of income to which such taxes relate, the allocations are within the Deemed PIP Safe Harbor.

(i) *<u>Example 4B</u>*

Assume the same facts as in Example 4A, except that the partnership agreement simply allocates CFTEs in accordance with section 704(b) book income and does not take allocations under section 704(c) into account. Under the CFTE Regulations, the allocations would not be within the Deemed PIP Safe Harbor and therefore would not be respected unless the taxpayer can satisfy the PIP standard.

(ii) *<u>Example 4C</u>*

Assume the same facts as in Example 4A, except that Country X allows the partnership to take a fair market value ($200,000) basis in the property for Country X tax purposes if the asset is booked in at that value for financial accounting purposes. Because the later sale of the property does not result in the realization of gain for Country X purposes, the business M income is therefore $250,000, and Country X tax is $50,000. Under the Proportionate to Income test, A can be allocated $25,000 (or 50%) of this CFTE because of the section 704(c) income, even though arguably none of the Country X tax is really attributable to pre-contribution gain in the sense that the pre-contribution gain was not included in the foreign country tax base. For U.S. tax purposes, there is $400,000 of business M income, $150,000 of which is section 704(c) gain allocated to partner A. The remaining $250,000 is allocated equally between partners A and B. The allocation of built-in gain to A "drags" with it under the Proportionate to Income rule some of the business M CFTEs. Yet, that built-in gain was not included in the Country X tax base. Accordingly, some of the CFTEs allocated to A are, under tracing principles, really "related" to income allocable to B.[63]

b. Applicability of Section 909

Example 4A does not seem to involve separation of foreign tax and related income as the U.S. and foreign tax bases are consistent. However, Example 4C arguably *does* result in a separation of foreign tax from "related" income (although generally there would not be "covered persons" unless the partners were related to one another). In that case, Country X allows a stepped-up basis upon contribution of the property. Thus, the pre-contribution gain is not included in the foreign country tax base, and the section 704(c) built-in gain allocated to partner B therefore should not be treated as "related" income. This is not a situation in which a foreign country imposes tax on income the U.S. does not recognize, like that in the disregarded inter-branch payment examples above. Rather, in this case the foreign country fails to tax what the U.S. perceives as taxable gain. The problem is that the Deemed PIP Safe Harbor, in measuring net income for purposes of determining a partner's distributive share of income in a CFTE category, looks to income determined based on, and allocated under, U.S. tax principles and then allocates CFTEs accordingly. The U.S. income resulting from the built-in gain is taken into account in computing the partner's distributive share of income from the branch and therefore "drags" within it other foreign taxes that were not imposed with respect to that gain. Indeed, the basis step-up Country X allows seems equivalent to permitting a deduction for the gross income allocation in Example 3 (*i.e.*, there is actually a net reduction in Country X tax base relative to U.S. tax base attributable to the section 704(c) gain rather than any CFTE). Accordingly, the results under the current Deemed PIP Safe Harbor in Examples 3 and 4 are conceptually inconsistent with one another. Applying "tracing" principles, the built-in gain allocated under section 704(c) should not be included in partner A's distributive share of income from business M. To the extent CFTEs are allocated to partner A because of that built-in gain under the traditional method, those CFTEs are really related to income that is allocated to partner B under the residual allocations.

[63] Arguably, however, this may constitute a base difference subject to the base difference rule in the Deemed PIP Safe Harbor, in which case separation would not result.

On the other hand, attempting to distinguish when section 704(c) items are consistent with the foreign country tax base by "tracing" these items to foreign taxes would involve significant complexity. While "tracing" appears relatively simple in the specific example above, built-in gain may, for example, be depreciated for section 704(b) book purposes. Attempting to discern the net effect over multiple taxable periods (with due regard to the effect of the taxpayer's choice of the traditional, curative, or remedial allocation method) is likely to be very complex and burdensome for the taxpayer and for the government when it audits such arrangements. Section 704(c) already includes anti-abuse rules that could be used to police cases of clear abuse in this context.[64]

V. Potential Revisions to the CFTE Regulations

We support the general approach of the CFTE Regulations in matching foreign tax credits with income and believe it is correct as a policy matter and generally consistent with section 909. As the examples above illustrate, the two primary situations in which arrangements permissible under the Deemed PIP Safe Harbor arguably achieve a separation of income and credits in a manner inconsistent with the policies underlying section 909 involve (1) the application of the Proportionate to Income test to disregarded inter-branch payments, and (2) its treatment of section 704(c) allocations if the foreign taxing jurisdiction does not apply a consistent approach to built-in gain and loss.

However, we believe caution is warranted. Comparable results can be achieved by taxpayers in situations not covered by the CFTE Regulations (which apply only when legal liability for the foreign tax is imposed on a partnership entity). Accordingly, revising the CFTE Regulations will create other discontinuities. For the reasons explained above, we also believe the likelihood of abusive arrangements that exploit these situations is relatively low, except in the case of disregarded inter-branch payments involving a partnership between related partners.

A. Alternative Approaches to Disregarded Inter-branch Transactions

To the extent the CFTE Regulations appear to bless results that could arguably be considered FTC Splitting Events, these arise from the Deemed PIP Safe Harbor, specifically the

64 Treas. Reg. § 1.704-3(a)(10).

Proportionate to Income test as applied to disregarded inter-branch payments. However, even if the government considers results like those in Example 2A FTC Splitter Events, the solution is not to abandon the Proportionate to Income test. Abandoning the Proportionate to Income test in favor of a mandatory "tracing regime" would create a regime that is more difficult to comply with and administer.

The major source of potentially CFTE allocations is the Disregarded Branch Payment rule. If that rule is eliminated from the Deemed PIP Safe-harbor, the tracing approach illustrated by Example 24(iv)[65], which is currently allowed only with adequate substantiation, should be mandated. We believe that Example 24(iv) reflects the allocation scheme most consistent with arrangements likely to be entered into by unrelated partners acting at arm's-length as a commercial matter. Such revisions would reasonably balance the need to address situations in which there is realistic potential for abuse without burdening other taxpayers (who are not likely engaged in such abuse) and IRS auditors with a burdensome alternative regime that may be difficult to apply and administer. If that approach is adopted, the current regulations should be revised to expressly state that an allocation of CFTEs that satisfies section 704(b) will satisfy section 909.

Alternatively, if the government is more narrowly focused on preventing violations of section 909 principles that may result from an allocation scheme like that in Example 24(ii)[66], the most administrable alternative approach would be to retain the current Deemed PIP Safe Harbor but make clear that merely because an allocation is deemed to be in accordance with PIP for section 704(b) allocation purposes does not mean that there has been no separation of credits from the related income for purposes of section 909. Section 704(b) regulations already provide that a valid allocation under section 704(b) does not preempt application of other operative provisions of law.[67] This approach would therefore be consistent with the premise of the existing CFTE Regulations. Treasury regulation sections 1.704-1(b)(1)(iii) and (iv) could be revised to specifically reference section 909 and include an example involving disregarded inter-branch payments and related partners in which section 909 applies despite the valid allocation of income

65 Treas. Reg. § 1.704-1(b)(5), Ex. 24(iv)

66 Treas. Reg. § 1.704-1(b)(5), Ex. 24(ii)

67 Treas. Reg. §§ 1.704-1(b)(1)(iii) and (iv).

under section 704(b).[68] If the Disregarded Branch Payment rule is not eliminated completely, however, it would be helpful to include an example like existing Example 24(iii) in the CFTE Regulations[69] involving unrelated partners to illustrate specifically that section 909 does not apply in that situation.[70]

The viability of the latter approach is premised on our conclusion that "covered person" should be tested at the partner level under section 909. This means that only a subset of arrangements like that in Example 2 above, specifically transactions involving related partners *and* disregarded inter-branch payments, would result in FTC Splitting Events, which also should be confirmed by future guidance under section 909.

To further minimize the impact of the rules on ordinary course commercial arrangements, the government could also consider exempting ordinary course business transactions from section 909, even when the transaction involves related partners. We recognize, however, the difficult "line drawing" problem this poses and acknowledge that section 909 is not, by its terms, an anti-abuse provision. Were this to be considered, a possible approach may be to permit even related party taxpayers to rely on the Disregarded Payment rule if they can clearly demonstrate by a preponderance of the evidence that an inter-branch transaction was entered into in the ordinary course of business and did not have as a purpose the separation of CFTEs and income to enhance the effective foreign tax rate on income allocable to any partner.

B. <u>Approach to Guaranteed Payments and Preferential Income Allocations</u>

The approach under the CFTE Regulations to guaranteed payments achieves results consistent with section 909 and should not be revised.

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68 *Cf.* Treas. Reg. § 1.704-1(b)(5), Ex. 28(ii).

69 Treas. Reg. § 1.704-1(b)(5), Ex,. 24(iii)

70 We do not recommend that allocations among unrelated partners in a manner consistent with the allocation approach in Example 24(ii) be treated as subject to section 909. It makes more sense that the CFTEs be reallocated to the appropriate partner under section 704(b) than permanently disallowed, which is the practical effect of respecting the allocation under section 704(b) but "suspending" the foreign tax credit under section 909 since the partner that is allocated the foreign tax credit generally will never include "related" income included by an economically unrelated partner.

C. **Approach to Section 704(c) Property and Basis Disparities**

While it may be appropriate, from the standpoint of theoretical purity, to amend the Deemed PIP Safe Harbor to address section 704(c) items, the current approach may hurt taxpayers as often as it helps them. Further, situations in which taxpayers with built-in gain or loss property will seek out a foreign jurisdiction in which to form a partnership on the basis that the country has an inconsistent approach to section 704(c) or section 723 in order to "shift" CFTEs among the partners seems likely to be rare and to involve the kind of highly structured transaction that likely can be adequately attacked using other anti-abuse doctrines including the anti-abuse rules under section 704(c).[71] Because the treatment of section 704(c) property, and resulting distortions of effective foreign tax rates, is not likely to be easily manipulated by partners, and because the complexity of tracing foreign taxes to items allocated under section 704(c) will be significant, we believe the current approach in the CFTE Regulations should be retained and, unless there are abusive situations we have not identified, we believe that the treatment of section 704(c) gain and loss in the current CFTE Regulations should not be treated as resulting in "separation" of CFTEs from income for purposes of section 909.

However, the government could consider revising the regulations to provide that section 704(c) gain is included in a partner's distributive share of net income for purposes of the Proportionate to Income test only to the extent the gain is also recognized for foreign country tax purposes.

VI. **Transition and Effective Date Issues**

Section 909 and the Notice by their terms would apply revisions to the CFTE Regulations under section 909 only for post-2010 tax years. As a general matter, we do not believe final revised CFTE Regulations should apply prospectively from the date final regulations are issued because taxpayers are already on notice that section 909 may apply to disregarded inter-branch payments by partnerships that have related partners. At least for "splitting" transactions involving related partners and disregarded inter-branch payments, the revised rules should apply to post-2010 taxable years.

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[71] Treas. Reg. § 1.704-3(a)(10).

However, it may be appropriate to provide relief in the case of a provision allocating CFTEs that was made part of a partnership agreement entered into prior to the enactment of section 909 circumstances similar to those contained in the transition relief that was provided under Treas. Reg. § 1.704-1(b)(2) in connection with the original CFTE Regulations.