NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON
ISSUES UNDER SECTION 909 OF THE CODE

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TABLE OF CONTENTS

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I. INTRODUCTION

This report[1] contains recommendations for administrative guidance under Section 909,[2] which is intended to prevent "splitting" transactions in which taxpayers claim credits or deductions for foreign taxes prior to including in income for U.S. tax purposes the income to which such taxes relate. Section 909 was enacted as part of P.L. 111-226 (the "Act") which was signed into law on August 10, 2010.

This report is divided into five parts. Part I is this Introduction; Part II discusses the background of the legislation enacting Section 909; Part III is a summary of the law; Part IV is a summary of our recommendations; and Part V is a discussion of the issues and our recommendations.

This report is intended to address interpretive issues regarding the application of Section 909. As discussed in detail below, the statutory language leaves many significant issues open. In addition, the legislative history is limited to a report prepared by the staff of the Joint

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1. The principal authors of this report are Andrew Braiterman, Peter Connors, David Hardy, and Ansgar Simon, as part of a working group that included Kimberly Blanchard, Charles Cope, Pamela Fuller, Joshua Gordon, Patrick Jackman, Erika Nijenhuis, Colleen O'Neill, James Peaslee, David Sicular, and Diana Wollman. Helpful comments were received from Peter Blessing, Michael Farber, David Hariton, William McRae, Michael Schler, and Andrew Solomon. The assistance of Meredith Stead is gratefully acknowledged.

2. Except as otherwise noted, "Section" references are to sections of the Internal Revenue Code of 1986, as amended.

Committee on Taxation[3] which does not provide a very detailed explanation of the operation of the provision. Given that many taxpayers will consider repatriations of income from foreign subsidiaries prior to the effective date of Section 909, we believe that guidance on key issues is urgently needed. Prompt guidance is also important for many taxpayers who will need to assess the impact of Section 909 on the availability of foreign tax credits as deferred tax assets in preparing their financial statements in the early part of 2011.

II. BACKGROUND

A. Summary of Foreign Tax Credit Regime

For U.S. federal income tax purposes, domestic corporations and U.S. resident individuals (together, "U.S. taxpayers") generally are taxed on their entire worldwide income, as determined for U.S. federal income tax purposes, regardless of its source. As foreign source income may be subject to foreign income or similar taxes, the U.S. federal income tax system has provided, since 1918, a credit against a U.S. taxpayer's U.S. tax liability for foreign income taxes paid or accrued in respect of foreign source income.[4] 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 the foreign jurisdiction and by the United States. The foreign tax credit regime in effect does this by unilaterally ceding primary taxing jurisdiction with respect to foreign source income to foreign jurisdictions.

3. Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010" (JCX-46-10), August 10, 2010 (hereinafter, the "JCT Report").

4. The limitation with respect to foreign income was first introduced in 1921. *See* U.S. Treas. Dept., *International Tax Reform: An Interim Report*, at 18 (Jan. 15, 1993), reprinted in 93 TAX NOTES TODAY 15-30, Tax Analyst Document Number Doc 93-970.

The creditable foreign taxes are "income, war profits and excess profits taxes," as described in detail in the regulations,[5] and taxes imposed as a substitute for such income, war profits and excess profits taxes, such as a gross basis withholding tax imposed by a foreign jurisdiction.[6]

Subject to the application of Section 909, the foreign tax credit works as follows. The "direct" foreign tax credit allows a U.S. taxpayer a foreign tax credit with respect to foreign taxes that it paid or accrued directly during the taxable year.[7] U.S. taxpayers may, however, elect to deduct such foreign taxes instead of claiming a direct foreign tax credit.[8]

The "indirect" foreign tax credit allows a domestic corporation to claim a foreign tax credit with respect to dividend distributions received from a foreign corporation in which it owns, directly, 10% or more of the voting stock (a "first-tier subsidiary").[9] In this case, the amount of the creditable foreign taxes deemed paid in respect of the dividend equals the same proportion of such foreign taxes paid or accrued by the foreign corporation after 1986 (and not attributable to previously distributed dividends) as the dividend bears to the post-1986 earnings and profits ("E&P") not previously distributed or included under subpart F.[10] The E&P of a

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5. Section 901(b)(1) and 902(c)(4); Treas. Reg. § 1.901-2(a) through (d).

6. Section 903 and Treas. Reg. § 1.903-1.

7. Section 901(a) and (b).

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

9. Section 902(a).

10. This applies to "post-1986 undistributed earnings" and "post-1986 foreign income taxes." Pre-1987 law applies to accumulated earnings and profits of pre-1987 periods and "pre-1987 foreign income taxes," but actual dividend distributions are treated as made first out of post-1986 earnings. Section 902(c)(6). The amount of the dividend is for this purpose not grossed-up by the amount of the associated foreign taxes, as is otherwise the case for purposes of determining the foreign tax credit limitation, as discussed below. *See* Treas. Reg. § 1.902-1(b)(1) & (c)(2); Section 78.

foreign corporation are, for this purpose, determined under U.S. federal income tax principles.[11] An indirect foreign tax credit is also available with respect to foreign income taxes paid or accrued by certain lower-tier subsidiaries of such first tier-subsidiary, if the domestic corporation indirectly owns at least 5% of the voting stock of the lower-tier subsidiary (together with the first-tier subsidiary, "Section 902 corporations").[12] Each higher-tier subsidiary is, for this purpose, deemed to have paid an amount of foreign income taxes of the lower-tier subsidiary from which it receives a dividend that is determined in the same manner as the indirect foreign tax credit of the U.S. corporation with respect to the first-tier corporation. Foreign income taxes thus "tier up" from lower-tier subsidiaries to higher-tier subsidiaries as dividends are distributed up the chain.

An indirect foreign tax credit is also available under Section 960(a)(1) to a corporate U.S. shareholder of a controlled foreign corporation that is a Section 902 corporation in respect of amounts currently includible in income by that U.S. shareholder under Section 951(a) – *i.e.*, subpart F income and amounts included as a result of investments in U.S. property under Section 956. The foreign tax credit is determined under Section 902 by treating the amount included under Section 951(a) as a dividend actually paid by the controlled foreign corporation to the corporate U.S. shareholder.[13] A foreign tax credit is similarly available for a

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11. Treas. Reg. § 1.902-1(a)(9) and Section 964(a).

12. Section 902(a) and (b). This applies to second and third tier subsidiaries; it applies to fourth, fifth and sixth tier subsidiaries only with respect to foreign taxes paid during taxable periods beginning after August 5, 1997, in which they are controlled foreign corporations within the meaning of Section 957(a), and certain additional restrictions apply. Treas. Reg. § 1.902-1(a)(4)(ii).

13. Sections 960(a), 951(b) and 957(a).

corporate U.S. taxpayer with respect to currently includible income of a passive foreign investment corporation with respect to which it has made a qualified electing fund election.[14]

The amount of allowable foreign tax credit is limited to the amount of U.S. tax attributable to foreign source net income, with separate limitations under the rules of Section 904(d) for passive category income, general category income and, for taxable years beginning after August 10, 2010, income that is resourced under applicable treaties. Within each such category or "basket" of foreign source income that is recognized for U.S. tax purposes, the foreign income and the associated foreign taxes can be blended and averaged for the purpose of calculating the foreign tax credit limitation. For each basket, the maximum amount of foreign tax credits equals the same proportion of the overall U.S. tax liability (as determined without regard to foreign tax credits) that the amount of foreign source income in the relevant basket bears to the U.S. taxpayer's worldwide income. 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 has "excess foreign tax credits" for any category for which its otherwise creditable foreign income taxes exceed this limitation. Such excess foreign tax credits can generally be carried back for one year and forward for ten years to any year in which the taxpayer is in an excess limitation position.[15]

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14. *See* Sections 1291(g), 1293(f) and 904(d)(2)(E)(ii).

15. Section 904(c).

E&P and foreign tax pools are calculated separately for each Section 902 corporation. This provides U.S. taxpayers with flexibility to manage their foreign tax credit situations by deciding whether to repatriate high-taxed or low-taxed foreign source income.[16]

An accrual basis U.S. taxpayer may take the foreign tax credit in the taxable year in which the foreign income tax accrues; a cash basis U.S. taxpayer may take the foreign tax credit either in the taxable year in which the foreign income tax is paid or, if it so elects, in the taxable year in which it accrues.[17] This may lead to timing differences if the foreign source income is taken into income for U.S. federal income tax purposes in a different taxable year from the year in which it is taken into income for foreign tax law purposes. In that case the foreign tax is allocated to the category of income determined "as if the income were recognized under United States tax principles in the year in which the tax was imposed."[18]

B. Technical Taxpayer Rule and *Guardian Industries*

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, as applicable, that is legally liable for the foreign tax under foreign law. This "Technical Taxpayer Rule" was first

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16. Recent legislative proposals by the Obama Administration and Representative Rangel would prevent selective repatriation by requiring a pooling of foreign tax credits. *See* New York State Bar Association Tax Section, *Report on Administration Proposals Regarding Deferral of Deductions Related to Deferred Foreign Income, Foreign Tax Credit Pooling, and Entity Classification Rules* (Report No. 1197, December 4, 2009), *available at* http://www.nysba.org; New York State Bar Association Tax Section, *Report on International Provisions of H.R. 3970 and Effects of Reduction in Corporate Tax Rates* (Report No. 1173, December 24, 2008), *available at* http://www.nysba.org.

17. Section 905(a); Treas. Reg. § 1.905-1(a). This election must be followed in subsequent years.

18. Treas. Reg. § 1.904-6(a)(1)(iv).

enunciated in *Biddle vs. Commissioner*,[19] and is currently reflected in Treas. Reg. § 1.901-2(f)(1), which provides:

> The person by whom tax is considered paid for purposes of Section 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (*e.g.*, a withholding agent) remits such tax.

The Technical Taxpayer Rule has been developed in a series of published rulings applying the rule to foreign taxes imposed on combined income of multiple companies and to partnerships and hybrid entities. Revenue Ruling 58-518[20] found the parent corporation, which was exclusively liable for tax under foreign law, to be eligible for the foreign tax credit on the tax paid in respect of its subsidiaries. In Revenue Ruling 72-197,[21] the owners of a foreign entity treated as a partnership for foreign tax purposes were held to be entitled to a foreign tax credit for foreign taxes imposed on the partnership's operation even though the entity was regarded as a corporation for U.S. tax purposes.[22]

While the Technical Taxpayer Rule can be criticized as mechanical, it succeeds at creating a simple and straightforward rule that can be easily applied.[23] However, as illustrated below, the Technical Taxpayer Rule, in conjunction with the timing rule for the recognition of foreign tax credits, allows for a separation or "splitting" of creditable foreign income taxes from the related foreign source income, thereby allowing for a reduction (and possibly elimination) of an excess limitation position by increasing the available creditable foreign taxes without

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19. 302 U.S. 573 (1938).

20. 1958-2 C.B. 381.

21. 1972-1 C.B. 215.

22. *See also Abbott Labs. Int'l Co. v. United States*, 160 F. Supp. 321 (D.C. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959).

23. *See* Yaron Z. Reich, *International Arbitrage Transactions Involving Creditable Taxes*, 85 TAXES 53, 63 (2007).

increasing the related foreign income taken into account for U.S. federal income tax purposes and subject to U.S. federal income tax.

Such splitting was the subject of *Guardian Industries Corp. v. Commissioner*.[24] A group of corporations organized in Luxembourg formed a fiscal unity under Luxembourg law. Under Luxembourg law, Guardian Industries Europe, S.a.r.l. ("GIE"), the parent of the fiscal unity, was legally liable for the tax on the aggregate income of the group. GIE, which was wholly owned by a member of the taxpayer's U.S. consolidated group, Interguard Holding Corp. ("IHC"), was treated as a disregarded entity for U.S. tax purposes (*i.e.*, a foreign hybrid), but its subsidiaries were treated as foreign corporations for U.S. tax purposes. The court, relying on foreign law experts to determine that GIE as the Luxembourg parent was legally liable for the Luxembourg group's entire tax, found that IHC was the technical taxpayer for U.S. foreign tax credit purposes and entitled to claim a foreign tax credit even though the associated income of the Luxembourg operating subsidiaries had not been actually distributed to the parent and therefore had not yet been included in income for U.S. tax purposes.

While many tax practitioners regard *Guardian Industries* as correctly decided based on then-existing law, it was recognized that the Technical Taxpayer Rule (as applicable at that time) can be exploited by, *e.g.*, a U.S. based multinational to use foreign income taxes to offset U.S. tax on other foreign source income while deferring the U.S. taxation of the foreign income to which the cross-credited foreign income taxes relate.

Similar to *Guardian Industries*, foreign income tax and foreign source income can also be separated by using a foreign reverse hybrid entity that is treated as a pass-through entity

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24. 65 Fed. Cl. 50, 2005–1 U.S.T.C. ¶50,263, *aff'd*, 477 F.3d 1368 (Fed. Cir. 2007).

in the foreign jurisdiction where it earns its income and as a foreign corporation for U.S. federal income tax purposes. If the tax laws of a foreign jurisdiction treat the owners of the reverse hybrid as partners in a partnership so that they have the legal liability to pay the income tax in respect of the reverse hybrid's income regardless of whether it is distributed, the Technical Taxpayer Rule (in conjunction with the timing rule) would allow the U.S. owners of the reverse hybrid a foreign tax credit with respect to the foreign taxes even though they do not take the income of the reverse hybrid into account for U.S. federal income tax purposes, because the reverse hybrid is not a pass-through entity for U.S. federal income tax purposes (assuming the income is not required to be currently included as, *e.g.*, subpart F income).

C. Proposed Amendments to the Technical Taxpayer and Compulsory Payment Regulations

Two sets of regulations have been proposed to address perceived shortcomings of the Technical Taxpayer Rules and other issues relating to transactions that could be viewed as splitting transactions. They largely address similar concerns to those that motivated the enactment of new Section 909, and in many cases reach the same result, but they approach foreign tax credit splitting transactions using a fundamentally different mechanism from Section 909, which is described in detail in Part III below. Before turning to Section 909, a brief discussion of these proposed regulations is therefore warranted.

Under the regulations currently in effect, the Technical Taxpayer Rule applies in the case of taxes on the combined income of related persons as follows:

> If foreign income tax is imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that

> is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.[25]

In May 2005, prior to the Court's decision in *Guardian Industries*, we submitted a report (the "2005 NYSBA Report")[26] to the Treasury making certain recommendations regarding the splitting opportunities presented in the *Guardian Industries* case. In the 2005 NYSBA Report, we described the historical antecedents to the Technical Taxpayer Rule as well as some of the hybrid entity and hybrid instrument transactional patterns which allowed foreign income to be split from the creditable foreign income tax. The Report recommended generally that the jointly and severally liable condition for allocating taxes of the existing Technical Taxpayer Rule be deleted, and that the definition of foreign tax imposed on combined income be clarified. Such clarification included that tax would be considered to have been imposed on combined income whenever the tax base includes the income of one or more related persons regardless of whether the persons are treated as entities for U.S. or foreign tax purposes and regardless of whether the persons are all earning income in a single jurisdiction. Notably, the 2005 NYSBA Report recommended that the combined income provisions not be applied to an integrated tax system (where a shareholder pays tax on corporate income but with an imputation credit for previously paid corporate tax) or to a group relief system (such as the U.K. regime where corporations are permitted to surrender losses to related corporations).

On August 4, 2006, the Treasury published proposed amendments to the Technical Taxpayer Rule following many of the recommendations of the 2005 NYSBA Report

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25. Treas. Reg. § 1.901-2(f)(3). *See also* Rev. Rul. 77-209, 1977-1 C.B. 238.

26. 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, April 4, 2005), 2005 TAX NOTES TODAY 64-26 ("2005 NYSBA Report"), *available at* http://www.nysba.org.

(the "Proposed Legal Liability Regulations").[27] The Proposed Legal Liability Regulations would allocate the foreign tax among combined income entities in proportion to their share of the foreign tax base regardless of which entities are required to pay the tax. Where the U.S. owner of a foreign reverse hybrid was liable for foreign tax but the foreign income was not taxed in the U.S., the foreign tax would be allocated to the reverse hybrid. The Proposed Legal Liability Regulations would not change the current rules under which foreign law ownership rules apply in determining the person that is legally liable for a foreign withholding tax where a different person is treated as the owner of the underlying instrument for U.S. tax purposes, *e.g.*, in the case of a repurchase transaction.[28] As recommended by the 2005 NYSBA Report, the Proposed Legal Liability Regulations would not apply to foreign regimes that permit one company to transfer losses to another company pursuant to a group relief or similar regime or to imputation regimes, nor would they apply to anti-deferral regimes similar to subpart F.[29]

The Proposed Legal Liability Regulations would also expand upon the current rules for allocating combined income among entities.[30] Allocation generally would follow foreign law. Where a loss of one member offsets income of one or more other members, mandatory provisions of applicable foreign law for allocating the loss among the profitable

27. REG-124152-06, 71 Fed. Reg. 44,240 (August 4, 2006).

28. Prop. Treas. Reg. §§ 1.901-2(f)(1)(ii) and 1.901-2(f)(6), Example 3.

29. Prop. Treas. Reg. § 1.901-2(f)(2)(ii)(A),(B) & (C).

30. Prop. Treas. Reg. § 1.901-2(f)(2)(iv).

members would be followed; absent such mandatory rules, pro rata allocation based upon the profitable members' income would apply.[31]

The Proposed Legal Liability Regulations were to have been effective for taxable years of taxpayers beginning on or after January 1, 2007. However, in Notice 2007-95,[32] Treasury deferred the effective date of the Proposed Legal Liability Regulations until after final regulations are published in the Federal Register. No such final regulations have been published to date.

On March 30, 2007, Treasury published a proposal to amend the non-compulsory payment regulations of Treas. Reg. § 1.901-2(e)(5)(iii) ("2007 Proposed Regulation").[33] The 2007 Proposed Regulation clarified that in the context of a group of foreign corporations, all 80% owned directly or indirectly by a U.S. corporation, the fact that one foreign member surrenders a loss to another foreign member in one year to reduce the second member's foreign tax does not make foreign tax subsequently paid by the first member in a later year non-compulsory and therefore ineligible for a U.S. foreign tax credit.[34] The 2007 Proposed Regulation has not been promulgated in final form. Under Notice 2007-95, the 2007 Proposed Regulation would be effective for taxable years beginning on or after the publication of final regulations, but taxpayers would be entitled to rely on that portion of the proposed regulation

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31. Prop. Treas. Reg. § 1.901-2(f)(2)(iv)(C).

32. 2007-49 I.R.B. 1091.

33. REG-156779-06, 72 Fed. Reg. 15,081 (March 30, 2007).

34. Mechanically, this result would be achieved by treating the group as a single corporation for purposes of applying the compulsory payment rules.

addressing U.S.-owned foreign groups for taxable years ending on or after March 29, 2007 and beginning prior to the date of finalization.

While the Proposed Legal Liability Regulations proposing changes to the Technical Taxpayer Rule responded to the *Guardian Industries* situation, the regulation received criticism both for being too broad and for being too narrow. The amendment to the Technical Taxpayer Rule would rely on foreign law for purposes of allocating the foreign tax base instead of looking to foreign law only for the evidentiary purpose of identifying the fact and incidence of tax. The proposal would also require U.S. taxpayers to make determinations of whether foreign ownership is consistent with U.S. rules applicable to entities (*e.g.*, hybrids) and the substance over form doctrine (*e.g.*, repurchase obligations). They were also viewed by some as too narrow in failing to clearly curtail all possible splitting transactions. And the group relief provisions contained in the 2007 Proposed Regulation were criticized as too narrow in applying only where 80% ownership existed and not lower levels of ownership.[35] Treasury has not released a subsequent version of the Proposed Legal Liability Regulations or the 2007 Proposed Regulation. Certainly, the issues are difficult. Some commentators suggested that, rather than adjust the Technical Taxpayer rule, a legislative change to link credits directly to the related income might seem attractive.[36] Absent the finalization of such proposed amendments, splitting transactions may have continued to occur under the old Technical Taxpayer Rule, subject to existing anti-abuse doctrines, until the enactment of new Section 909.

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35. *See* New York State Bar Association Tax Section, *Report on Proposed Section 901 Regulations Relating to Compulsory Payments of Foreign Taxes* (Report No. 1135, October 25, 2007), 2007 TAX NOTES TODAY 208-14, *available at* http://www.nysba.org.

36. Reich, *supra* note 23, at 65.

III. SUMMARY OF NEW SECTION 909

Section 909 imposes a deferral or matching regime for foreign income taxes paid or accrued either by a U.S. taxpayer (in the case of a direct foreign tax credit or deduction for a taxpayer that does not elect to credit foreign taxes) or a Section 902 corporation (in the case of an indirect foreign tax credit) that are part of a "foreign tax credit splitting event" (a "Splitting Event") and the related foreign income.[37] A Splitting Event with respect to any portion of any foreign income tax paid or accrued by the relevant person occurs if the foreign income (in the case of a direct foreign tax credit) or the E&P (in the case of an indirect foreign tax credit) to which such taxes relate (the "related income") is taken into account under U.S. tax principles by a "covered person."[38]

Whether a person is a covered person depends on the person's relationship with the payor of the tax. 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 an entity that is at least 10 percent (by vote or value) directly or indirectly owned by such person; or (3) is related to such person under Section 267(b) or Section 707(b); in addition, "any other person specified by the Secretary" may be treated as a covered person.[39]

For direct foreign tax credit purposes, the deferral regime requires that the foreign income tax paid or accrued by a taxpayer be taken into account (*i.e.*, credited subject to the limitations described above) in the taxable year in which the taxpayer takes into account (for

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37. Sections 909(a) and (b). "Foreign income tax" is defined in the same manner as under Section 901 and includes tax paid in lieu of such a foreign income tax, as defined under Section 903. Section 909(d)(2). *See* JCT Report at 5.

38. Section 909(d)(1) and (3).

39. Section 909(d)(4).

U.S. federal income tax purposes) the related income.[40] The U.S. dollar amount of the foreign income taxes paid or accrued, however, 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.[41] Otherwise, 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.[42]

For indirect foreign tax credit purposes, under the Section 909 regime the foreign income tax paid by the Section 902 corporation as part of the Splitting Event is taken into account in the taxable year in which the related income is taken into account for U.S. federal income tax purposes by such Section 902 corporation or by a U.S. corporation which meets the requirements of Section 902(a) or (b) with respect to such Section 902 corporation. Thus, the foreign income tax paid or accrued by the Section 902 corporation (1) is added to its foreign tax pool for purposes of Sections 902 and 960, and (2) reduces its E&P under Section 964(a), in the taxable year when the related income is taken into account by the Section 902 corporation or applicable U.S. corporation.[43]

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40. Section 909(a) and (c)(2). The same deferral rule applies to a U.S. taxpayer that elects to deduct rather than to credit foreign taxes.

41. *Id.* Treasury is also given the authority to provide additional exceptions.

42. *See* JCT Report at 6.

43. Section 909(b) and (c)(2). *See* JCT Report at 5.

Treasury has been given significant regulatory authority under Section 909. It is authorized to expand through future regulations the scope of "covered person" to "any other person" it so specifies, and the JCT Report specifically mentions "an unrelated counterparty … in certain sale-repurchase transactions and certain other transactions deemed abusive" without further elaborating.[44] It is also authorized to issue regulations or other guidance "for the proper application of this section with respect to hybrid instruments."[45]

Treasury is further authorized to issue any other regulations or guidance "necessary or appropriate to carry out the purposes of this section, including … appropriate exceptions."[46] The JCT Report specifically mentions liquidations (of the taxpayer, the Section 902 corporation or the covered person), disregarded payments, and group relief.

Section 909 generally will be effective with respect to foreign income taxes paid or accrued in taxable years beginning after December 31, 2010.[47] However, for purposes of determining the indirect foreign tax credit with respect to dividends paid or inclusions under Section 951(a) made in such taxable years (and only for such years), Section 909 also applies with respect to foreign income taxes paid or accrued by a Section 902 corporation in taxable years beginning on or before December 31, 2010.[48]

IV. SUMMARY OF RECOMMENDATIONS

As discussed in more detail below, our principal recommendations are that:

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44. JCT Report at 5.

45. Section 909(e)(2). The JCT Report provides an example relating to hybrid instruments discussed at V.A.4, below.

46. Section 909(e).

47. Section 211(c)(1) of the Act.

48. Section 211(c)(2) of the Act.

1. Splitting Events be limited to situations in which the payor of the foreign tax (as determined under the Technical Taxpayer Rule) is different from the person that recognizes the related foreign income (as determined for U.S. tax purposes); and timing or base differences between U.S. and foreign tax law not give rise to Splitting Events.

2. guidance clarify that the use of a partnership or disregarded entity is not in and of itself a Splitting Event.

3. more detailed guidance be given with respect to the potential applicability of Section 909 to the use of hybrid instruments beyond the example in the JCT Report. In particular, we suggest that guidance address situations in which tax liability is shifted between jurisdictions.

4. guidance be given as to under what circumstances, if any, it may be appropriate to treat unrelated parties in certain repurchase transactions as covered persons (see the JCT Report). However, we do not believe that typical repurchase agreements involving unrelated persons should be treated as resulting in Splitting Events.

5. guidance be given with respect to the circumstances, if any, in which group relief regimes should give rise to Splitting Events. We have suggested some relevant considerations. We believe that it is appropriate in this regard to consider the likelihood that a group relief regime will result in a separation of foreign tax from E&P.

6. guidance clarify that the principle discussed in the JCT Report that distributions and deemed distributions from CFCs to covered persons do not in and of themselves result in Splitting Events is not limited to distributions and deemed distributions that occur in the year the income is earned.

7. guidance clarify that transfer pricing adjustments do not give rise to Splitting Events.

8. any administrative guidance expanding the definition of Splitting Events beyond situations involving combined returns, reverse hybrid entities, and hybrid instruments similar to that described in the JCT Report generally be prospective only in application, except in abusive situations.

9. guidance provide that, in situations involving combined returns, the Proposed Legal Liability Regulations' methodology for associating income with foreign taxes based upon foreign tax principles for calculating income is generally appropriate.

10. guidance provide that, where a Section 902 corporation pays a foreign tax that is subject to Section 909, but the related income is taken into account by a related U.S. taxpayer without being taken into account by the Section 902 corporation that paid the tax (*e.g.*, because such Section 902 corporation and the covered person are in different ownership chains or the covered person makes a Section 956 investment), the foreign tax credit may be claimed by the U.S. taxpayer at the time it takes into account the related income.

11. guidance clarify that, where the covered person's total E&P is less than the E&P attributable to related income because the covered person has losses from other activities, a distribution from the covered person should be deemed to result in the same percentage of the related income being taken into account as the percentage of total E&P that is distributed.

12. guidance provide that, where a covered person has E&P from related income as well as other E&P, distributions generally are deemed to come proportionally out of E&P arising from related income and other income, although we note that there are arguments in

favor of treating distributions as coming first out of related income E&P. In the case of hybrid instruments, tracing may be appropriate to determine when related income is taken into account.

13. guidance provide that, where the payor of the foreign tax or the covered person is liquidated or otherwise ceases to exist in a Section 381 transaction, the successor succeeds to the transferor's position for purposes of Section 909. In other situations where the relationship between the parties is not preserved (including non-Section 381 liquidations as well as sale transactions), we believe that some form of relief should be permitted to take into account the fact that the U.S. taxpayer or Section 902 corporation did in fact bear the burden of the foreign tax.

14. taxpayers be permitted to apply the Proposed Legal Liability Regulations, at least with respect to combined groups, with appropriate modifications, until the issuance of guidance under Section 909. More generally, we believe that the Proposed Legal Liability Regulations achieve many of the same objectives as Section 909 and are easier to administer and thus should be finalized, with appropriate modifications. We recognize that the application of the Proposed Legal Liability Regulations to reverse hybrid entities may be problematic.

15. in order to alleviate the burden of making determinations under Section 909, simplified rules be provided for pre-2011 foreign taxes. In particular, we recommend that Splitting Events for foreign taxes paid in such years should be limited to situations involving combined returns, reverse hybrid entities, hybrid instruments similar to those described in the JCT Report, or abusive situations.

V. DISCUSSION

A. Definition of Splitting Event

1. Generally

Perhaps the most important definitional issue under Section 909 is determining when a Splitting Event has occurred. The analysis begins when the technical taxpayer under existing rules (generally the payor of the tax) has paid or accrued a foreign income tax. The provision applies whenever income to which a foreign tax relates (the "related income") is or will be recognized by a "covered person" that is related to, but not the same as, the technical taxpayer or is an unrelated person specified pursuant to the Secretary's regulatory authority. In turn, the term "related income" means, with respect to any portion of any foreign income tax, the income (or, as appropriate, E&P) calculated under U.S. tax principles, to which such portion of the foreign income tax relates. The test for whether a Splitting Event occurs is generally an objective one, determined without regard to the taxpayer's intent (or lack thereof) to avoid taxes.

Thus, there should be a Splitting Event when there is a difference between the party that is liable for tax under the Technical Taxpayer Rule, and the party that recognizes the income (determined under U.S. tax principles), and the party that recognizes the income is a covered person. As IRS and Treasury officials have informally acknowledged, there should be no Splitting Event where there is merely a difference between the tax base under U.S. and foreign principles. Because "related income" is determined by reference to U.S. tax principles, there generally should not be a Splitting Event if (1) foreign tax is imposed on income (as determined under principles of applicable foreign tax laws) that is not treated as income for U.S.

federal income tax purposes[49] or (2) there is only a timing difference for the recognition of income by the same U.S. taxpayer or Section 902 corporation that is legally liable for the foreign income tax as a result of tax accounting differences between U.S. federal and foreign income tax law.[50] Thus, items of income under U.S. federal income tax law that are not treated as income under foreign tax laws should likewise not give rise to a Splitting Event.

2. Reverse Hybrid Entities and Combined Groups

Section 909 clearly applies where a reverse hybrid entity treated as a corporation for U.S. tax purposes and a pass-through for foreign tax purposes earns foreign income and one or more of the owners is liable for the taxes payable under foreign law. Similarly, there is clearly a Splitting Event in the case of a combined return[51] where the parent is solely liable for the tax on income recognized by its subsidiaries,[52] absent finalization of the Proposed Legal Liability Regulations,[53] and where the members of the group are covered persons.

3. Hybrid Entities Other Than Reverse Hybrids

Where foreign taxes are paid by a foreign entity that is treated as a taxable corporation for foreign tax purposes but as a partnership or disregarded entity for U.S. tax

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49. *See also* Treas. Reg. § 1.904-6(a)(1)(iv) (allocating foreign taxes imposed in respect of an item of income that does not constitute income under United States tax principles to the general basket); preamble of T.D. 8805 (Dec. 15, 1998) ("Treasury and the Service believe that a base difference exists within the meaning of §1.904-6(a)(1)(iv) only when a foreign country taxes items that the United States would never treat as taxable income, for example, gifts or life insurance proceeds."). *See* R. Huffman and A. Fischl, *Section 904 – Base Difference vs. Timing Difference for Foreign Taxes*, 31 TAX ADVISER 484 (July 2000).

50. *See* JCT Report at 5. *See also* note 18, *supra*, and related text.

51. References in this report to combined returns are intended to encompass any system in which tax is imposed based upon the combined income of two or more entities.

52. However, where there is joint and several liability between the parent and the subsidiaries, the Technical Taxpayer Rule generally would apply in a manner that avoids treatment as a Splitting Event.

53. The relationship between the Proposed Legal Liability Regulations and Section 909 is discussed in more detail at V.C, below.

purposes, the literal language of Section 909 arguably suggests that there is a Splitting Event, at least in the case of a partnership.[54] However, we believe that it is clear that the provision should only apply where U.S. tax law treats the income as earned by a person other than the person who is the technical taxpayer. For example, assume that a U.S. taxpayer owns 100% of the stock of a U.K. entity that is treated as a disregarded entity for U.S. tax purposes but as a corporation for U.K. tax purposes. Both the taxes and the income pass through to the U.S. person for U.S. tax purposes. In and of itself, this should not result in a Splitting Event.[55] Similarly, in the case of a hybrid entity treated as a partnership for U.S. tax purposes, there should be no Splitting Event because both the foreign income and the foreign tax pass through to the partners for U.S. tax purposes and the rules for allocating creditable foreign taxes among partners generally ensure a proper matching of income and credits.[56]

4. Hybrid Instruments

Section 909(e)(2) authorizes the Secretary to provide guidance as to the proper application of Section 909 to hybrid instruments. The term "hybrid instruments" generally refers to instruments whose character as debt or equity for income tax purposes is determined differently under U.S. and foreign tax law. For example, some jurisdictions treat perpetual debt instruments as valid indebtedness with respect to which interest is deductible. By contrast, the

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54. The "covered person" definition under Section 909(d)(4) includes only "entities" and "persons." A disregarded entity generally is considered to be neither an entity nor a person.

55. However, use of a hybrid entity in conjunction with other circumstances (*e.g.*, use of a group relief regime) may result in a Splitting Event. *See* Example 4 at V.A.6, below.

56. Treas. Reg. § 1.704-1(b)(4)(viii). Similarly, use of a non-hybrid partnership should not in and of itself give rise to a Splitting Event. Even if use of a partnership did give rise to a Splitting Event, the related income would be taken into account in the year the foreign tax is paid or accrued. If, however, a partner is party to a Splitting Event (*e.g.*, if the partner is a reverse hybrid entity), Section 909(c)(1) appropriately provides for application of Section 909 at the partner level.

U.S. treats the presence of a fixed maturity date as a *sine qua non* of debt status and accordingly the perpetual debt instrument is regarded as equity for U.S. tax purposes.[57] Thus, perpetual debt can be a hybrid instrument.

The JCT Report provides an example applying Section 909 to a hybrid instrument treated as debt for foreign tax purposes and equity for U.S. tax purposes:

> U.S. Corp, a domestic corporation, wholly owns CFC1, a country A corporation. CFC1, in turn, wholly owns CFC2, a country A corporation. CFC2 is 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.[58]

In the JCT Report example, the hybrid instrument issued by CFC2 to CFC1 does not reduce the aggregate amount of tax to be paid in the foreign jurisdiction, but merely shifts the tax from CFC2 to CFC1, an entity which has no E&P for U.S. tax purposes. The effect of the transaction is more than a timing difference; like other Splitting Events, it results in the foreign tax being paid or accrued by a different entity from the entity that has E&P for U.S. tax purposes. For this reason, we believe that application of the Section 909 deferral rules is appropriate.

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57. *See* Notice 94-47, 1994-1 C.B. 357; TAM 200650017 (Aug. 18, 2006).

58. JCT Report at 6.

A hybrid instrument can also result in a shifting of tax between foreign jurisdictions along with a separation of foreign taxes from income as determined for U.S. tax purposes:

> Example 1: Assume the same facts as in the example from the JCT Report, except that CFC1 is a country B corporation, country B (like country A) treats the hybrid instrument as debt, and CFC1 is subject to country B tax (but not to country A tax) on the interest income.

It can be argued that this modified example should not give rise to a Splitting Event on the ground that the country B tax imposed on CFC1 should not be viewed as related to the income of CFC2, which is not doing business in country B. However, we believe that there is still a Splitting Event – the hybrid instrument results in CFC2 having E&P for U.S. tax purposes and CFC1 incurring a foreign tax.[59]

5. Repurchase Transactions

Repurchase transactions may have effects similar to those of hybrid instruments. For example, a corporation holding preferred stock of a subsidiary may sell such stock to a related or unrelated person in exchange for cash pursuant to an agreement whereby the seller is obliged to repurchase (and the purchaser is required to resell) the preferred stock on a date certain for a price equal to the original sale price plus a yield approximating a market interest rate. Where the repurchase obligation is fixed as to amount, timing and yield, the U.S. substance-over-form doctrine generally regards such structures as a borrowing by the "seller" of the stock from the "purchaser" of the stock that is secured by the preferred stock and not as a

59. If, on the other hand, CFC1 were incorporated in a tax haven jurisdiction and incurred no foreign tax, there would be no foreign tax that could give rise to a Splitting Event.

transfer of the tax ownership of the preferred stock from the “seller” to the “purchaser.”[60] However, a foreign jurisdiction that is form driven may regard the purchaser, as owner of legal title to the transferred stock, as the owner for foreign tax purposes until the repurchase obligation matures and legal title to the stock is retransferred. Accordingly, payments of dividends on the preferred stock to the holder of legal title to the stock would be regarded for foreign tax purposes as giving rise to (potentially tax-exempt) dividend income to the holder of legal title (the purchaser for foreign tax purposes), but for U.S. tax purposes, the original seller under the repurchase agreement would be treated as receiving the dividends paid on the preferred stock and as accruing interest, which is deductible subject to generally applicable limitations, on the repurchase obligation.

The JCT Report states that the definition of “covered person,” which the statute provides may include “any other person specified by the Secretary,” permits the Secretary to 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 does not provide specific guidance or examples as to when a repurchase transaction may be viewed as abusive and giving rise to a Splitting Event. The issues posed are complex.

> Example 2: U.S. corporation P owns all the stock of foreign corporation CFC1. CFC1 in turn owns all the common and preferred stock of foreign corporation CFC2. CFC1 “sells” the preferred shares to B, an unrelated bank, which is obligated to resell the shares to CFC1 on a fixed date for an amount equal to the original purchase price plus an amount equivalent to interest. The transaction is treated as a secured borrowing for U.S. tax purposes, and CFC1 includes the dividend and a proportional share of CFC2’s foreign taxes in its E&P and

60. *See, e.g., Union Planters Nat’l Bank v. United States*, 426 F.2d 115 (6th Cir. 1970); *Nebraska Dept. of Rev. v. Loewenstein,* 513 U.S. 123 (1994); Rev. Rul. 74-27, 1974-1 C.B. 24; PLR 9125038 (Mar. 27, 1991).

> foreign tax pools, but, for foreign tax purposes, B is treated as owning the preferred shares prior to the resale and potentially entitled to a credit in its home jurisdiction for foreign taxes paid by CFC2.

We do not believe that a repurchase transaction similar to that in Example 2 should be treated as giving rise to a Splitting Event. The same foreign entity, CFC2, recognizes income (for U.S. tax purposes) and pays and accrues the foreign income taxes in respect thereof. Moreover, as a result of the dividend received for U.S. tax purposes by CFC1, the E&P pool and the foreign tax pool of CFC1 (and not any other person) will be increased, and those of CFC2 will be decreased, under generally applicable U.S. tax law principles. Although CFC1 reduces its E&P for U.S. tax purposes by reason of the repurchase transaction, a repurchase transaction is in that respect no different from any other secured or unsecured borrowing from an unrelated person. While it can be argued that the U.S. parent should not be entitled to the foreign tax credit for the taxes paid by CFC2 that are associated with the dividend since there may be no or only minimal double taxation, the fact that a borrowing in the form of a repurchase transaction is treated differently for foreign tax purposes should be irrelevant for Section 909 purposes because the different treatment under foreign law does not affect the amount or timing of the accrual of foreign taxes by CFC1 or the application of the relevant U.S. tax provisions. To the extent that there is any foreign tax credit related abuse, it would appear to be the potential duplicative benefit realized by P and B (each of which may be entitled to a foreign tax credit for taxes paid by CFC2); this arrangement potentially would be subject to the structured passive investment arrangement rules of Temp. Treas. Reg. § 1.901-2T(e)(5)(iv).

A repurchase transaction may also result in a U.S. taxpayer or its CFC being treated for foreign tax purposes as the owner of a security issued by an unrelated foreign party while a related or unrelated foreign counterparty is treated as the owner for U.S. tax purposes --

e.g., where the U.S. party acquires legal title to the security but is treated for U.S. tax purposes as if it made a loan to the foreign counterparty. As a result, the U.S. taxpayer may be treated as legally liable for foreign withholding tax on interest or dividends paid on the security under the Technical Taxpayer Rule and therefore entitled to a foreign tax credit, even though the interest or dividend income is treated as earned by the counterparty for foreign tax purposes. It is arguably appropriate to treat the foreign counterparty as a covered person that takes into account the income related to the foreign withholding tax. However, unlike a typical Splitting Event, the repurchase agreement does not reduce the U.S. taxpayer's income; instead it results in the income having a different character for U.S. and foreign tax purposes. We believe that this fact pattern is adequately addressed by the holding period requirements of Section 901(k) and (l).

For the reasons set forth above, we do not believe that typical repurchase transactions similar to those discussed above should give rise to Splitting Events. However, we recognize that Treasury and the IRS may identify types of repurchase transactions to which Section 909 should apply.

6. Group Relief

The possible application of Section 909 to group relief is referred to in the JCT Report as within the Secretary's grant of regulatory authority.[61] There is no indication in the legislative history as to what is intended. Under a typical group relief regime, a company's current year losses can be transferred to a profitable affiliate.

> Example 3: A U.K. company, UK1, owns all the shares of two other U.K. companies, UK2 and UK3. In Year 1, UK1 has no income or loss and UK2 has a loss of £1,000, which it transfers to UK 3, which has income of

61. The JCT Report states that it is anticipated that the Secretary may also provide guidance as to the proper application of the provision in cases involving disregarded payments, group relief, or other arrangements having a similar effect. JCT Report at 6.

> £1,000. In the next year, UK2 has income of £1,000, which it is unable to offset with a carryover of its prior year loss because the loss was surrendered to UK3, and UK2 pays a U.K. tax of £300.

In Example 3, UK2 incurs £300 in U.K. tax in Year 2 even though it has no net E&P for the two years in question, while UK3 has £1,000 in E&P for the two years but pays no U.K. tax. The application of Section 909 is arguably appropriate. The transfer of the Year 1 loss under the group relief regime results in UK2 paying tax but only UK3 having net E&P on a cumulative basis. This is the same net result as a Splitting Event. On the other hand, it can also be argued that treatment of this situation as a Splitting Event unduly stretches the statutory language. The U.K. tax paid by UK2 in Year 2 relates directly to UK2's own income in that year, which is not recognized by a covered person. Generally excluding group relief situations from Section 909 would be consistent with Treasury's conscious decision in promulgating the Proposed Legal Liability Regulations and the 2007 Proposed Regulation not to change the treatment of foreign tax credits in connection with group relief regimes. Even in combined return situations to which the Proposed Legal Liability Regulations would apply, use of one member's current year losses to offset another member's income in the same year would not trigger a change in the identification of the "technical taxpayer" or denial of credit under the compulsory payment rule in the case of tax paid on a later year's income.

One possible approach would be to limit the application of Section 909 in group relief situations to cases in which the transfer of the loss is likely to have a principal purpose of manipulating the foreign tax credit as opposed to simply minimizing foreign tax liability. This analysis could be based at least in part on the degree of certainty that the surrendered loss could have been used to offset the income of the payor of the foreign tax in a subsequent period.

Where the foreign tax law does not permit carryforwards, the case for applying Section 909 would be weakest.[62]

There are situations in which we believe that transfer of losses pursuant to a group relief system should likely result in a Splitting Event because the splitting of income and foreign tax liability occurs in a single year and it is therefore certain that the payor of the tax could have used the surrendered loss to offset foreign tax on income that the U.S. treats as the payor's own income.

> Example 4: U.S. corporation P owns all the stock of U.K. corporation UK1, which in turn owns all the stock of U.K. corporations UK2 and UK3. UK1 and UK2 are corporations for U.S. tax purposes, and UK3 is a disregarded entity. In Year 1, UK1 and UK2 each has income of £1000 and UK3 has a loss of £1000. UK3 elects to surrender its loss to UK2 rather than to UK1, with the result that UK1 incurs £300 in U.K. tax liability and UK2 incurs no U.K. tax liability.

Because UK3 is a disregarded entity and its loss passes through to UK1 for U.S. tax purposes, UK1 has no E&P for U.S. tax purposes (absent relevant timing differences between U.S. and U.K. tax law) but pays U.K. tax, while UK2 has positive E&P but no U.K. tax liability. If UK3 had surrendered its loss to UK1 instead of to UK2, UK2 would have incurred the U.K. tax liability and would have had E&P for U.S. tax purposes, while UK1 would have incurred no U.K. tax and would have had no E&P for U.S. tax purposes. Application of Section 909 appears to be appropriate.

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62. This recommendation arguably is inconsistent with the general approach of Section 909, which is to determine the existence of a Splitting Event without regard to the taxpayer's intent. However, we think that rules can objectively identify situations in which the essence of an arrangement (as opposed to an incidental effect) is the separation of foreign tax from related income.

7. Transfer Pricing Adjustments

It has been suggested that transfer pricing adjustments (either by the Service, without correlative adjustments by foreign jurisdictions, or by one or more foreign jurisdictions, without correlative adjustments by the U.S.) may implicate Section 909 in situations where such adjustments arguably result in foreign taxes being paid by an entity other than the entity which the U.S. considers to have earned the related income. We believe that it is inappropriate to treat transfer pricing adjustments as resulting in Splitting Events. In most cases where the IRS asserts Section 482, the effect is to bring income into the U.S. with the result that the concerns underlying Section 909 are not implicated. In other situations where income is shifted among entities as a result of transfer pricing adjustments imposed by the Service or foreign taxing authorities, with the result that a foreign entity is subject to a high rate of foreign tax in relation to E&P as determined for U.S. tax purposes, this high effective rate generally is real and not a product of manipulation or planning by the taxpayer. To the extent that there is a potential for abuse by taxpayers who do not take adequate steps to contest foreign taxes resulting from transfer pricing adjustments, the compulsory payment regulations can apply to deny the foreign tax credit.[63]

8. Dividends from Controlled Foreign Corporations

Questions have also been raised as to the treatment of dividends paid by controlled foreign corporations (“CFCs”). It could be argued that if a CFC earns income and pays foreign tax, there is a Splitting Event if the E&P will later be taken into income by a U.S. taxpayer that is a covered person as a dividend, as subpart F income, or as a Section 956

63. Treas. Reg. § 1.901-2 (e)(5)(ii), Example 1.

inclusion. There clearly should not be a Splitting Event where the CFC pays a foreign tax and includes the related income in its E&P, regardless of whether there is a current year or later distribution or deemed distribution of the earnings. The JCT Report states that it is not intended that there be a Splitting Event when, for example, a CFC pays or accrues a foreign income tax and takes into account the related income in the "same year," even though the E&P to which the foreign income tax relates may be distributed to a covered person as a dividend or included in such covered person's income under subpart F.[64] The reference in the JCT Report to the "same year" has led to concern that a different result might apply if the covered person's dividend inclusion occurs in a later year. Administrative guidance should clarify that the year of the inclusion in this situation is irrelevant.

9. Effective Date for Possible Expansion of Splitting Event Definition

To the extent that the Treasury and the Service determine that it is appropriate to expand the definition of Splitting Events beyond combined returns, reverse hybrid entities, and hybrid instruments similar to the one described in the example in the JCT Report, we believe that, at least in the absence of circumstances that clearly indicate abuse, any expanded definition should take the form of published guidance and should only be prospective. This is appropriate in light of the substantial uncertainties posed by the statute as drafted.

B. Timing for Taking Credit into Account

1. Generally

Section 909(a) provides that if there is a Splitting Event with respect to a foreign tax paid or accrued directly by a U.S. taxpayer, the tax is taken into account for foreign tax credit purposes when the related income is taken into account by the taxpayer. Similarly,

64. JCT Report at 5, n. 21.

Section 909(b) provides that if there is a Splitting Event with respect to a foreign income tax paid or accrued by a Section 902 corporation, the foreign tax is not taken into account for purposes of Section 902 or 960 or for purposes of computing E&P under Section 964(a) before the taxable year in which the related income is taken into account by the Section 902 corporation or by a domestic corporation which meets the ownership requirements of Section 902(a) or (b) with respect to the Section 902 corporation.

The Act does not provide any specific rules as to when a taxpayer or Section 902 corporation is treated as taking related income into account, nor does the JCT Report provide any guidance as to Congressional intent in this regard. As discussed in more detail below, in many cases the answer to this timing question is far from obvious. Administrative guidance with respect to timing issues is urgently needed.

By way of contrast, there is no serious ambiguity as to timing under the Proposed Legal Liability Regulations, which, as discussed above, address similar issues to those addressed by Section 909. The Proposed Legal Liability Regulations would provide that the foreign taxes are treated as paid by the entity that earns the income. The timing of the credit would then be governed by the normal rules of Sections 902 and 960. As discussed at V.C., below, finalization of the Proposed Limited Liability Regulations would reduce the scope of Splitting Events subject to Section 909 and therefore would reduce the need for complex timing determinations under Section 909.

2. Determination of Whether Covered Person Takes into Account Related Income

Application of Section 909 requires an initial determination of the extent to which a covered person earns the related income. In the combined return context, we believe that rules similar to those of the Proposed Legal Liability Regulations, which apply foreign tax principles to attribute foreign taxes to foreign income of group members, are appropriate. Although application of U.S. principles may at first blush seem more appropriate, this would inevitably result in applying Section 909 to timing differences, contrary to the statutory language and legislative history.

> Example 5: Foreign corporations X and Y file a combined foreign tax return. In Year 1, X and Y each has income of 100 as determined for foreign tax purposes. However, for U.S. tax purposes 50 of X's income is not recognized until Year 2. The combined income is subject to a foreign tax of 50, for which X bears sole liability under foreign law.

This example illustrates how there may be concerns where there is a difference in income recognized by U.S. and foreign tax principles. In this situation, we believe that it is appropriate to treat only half of the Year 2 foreign tax liability as associated with income earned by Y and thus subject to Section 909, rather than applying U.S. principles and treating two-thirds of the liability as associated with income earned by Y on the basis that Y earned 100 of the total 150 in E&P. The discrepancy between X's Year 1 income for U.S. and foreign tax purposes is solely due to a timing difference. Our recommended approach produces the same result that would apply if X and Y filed separate foreign returns and each paid tax on its own income.

It would, however, be appropriate to make adjustments in situations where intercompany transactions are ignored for foreign tax purposes and taken into account for U.S. tax purposes; this is analogous to the treatment of hybrid instruments discussed in V.A.4, above.

In addition, to the extent that it is determined that use of one group member's losses to offset current year income of another member in a group relief context should be treated as a Splitting Event, as discussed at V.A.6, above, it would be appropriate to modify the Proposed Legal Liability Regulations' allocation methodology as well in both group relief and combined return situations.

3. Time When Related Income Taken into Account Where No Change in Ownership

a. Basic Rule

It is clear that where a U.S. taxpayer has paid or accrued foreign taxes to which the splitting rule applies, the taxpayer should be entitled to take such taxes into account when the relevant E&P of the covered person is included in the taxpayer's income. This should apply whether the E&P is taken into account as a dividend (including an amount treated as a dividend under Section 304 or Section 356), as subpart F income, under Section 1248, or as a result of a Section 956 investment in U.S. property.

Similarly, where a Section 902 corporation pays or accrues the foreign tax and in a later year receives a dividend of the relevant E&P from the covered person (assuming that the dividend is excluded from subpart F income under Section 954(c)(3) or (if it is extended) Section 954(c)(6)) or is treated as receiving such a dividend under Section 964(e), the E&P and the foreign tax should be included in the pools of the corporation that paid the tax in the year of the dividend. Thereafter, the normal rules of Section 902 should apply.

Section 909(b)(2) also provides that where a U.S. shareholder of a Section 902 corporation that paid or accrued foreign taxes in a Splitting Event takes into account the covered person's relevant E&P, the foreign tax is taken into account. The statutory language suggests that this results in the foreign tax being taken into account in the E&P and foreign tax pools of the Section 902 corporation that paid the tax, following which the normal rules of Section 902 would apply to determine when the credit can be claimed. However, in cases where the covered person's E&P bypasses the Section 902 corporation that paid the foreign tax (*e.g.*, because the two entities are not in the same chain of ownership or the covered person makes a Section 956 investment), there may be undue impediments to ever being able to claim the foreign tax credit, especially if the Section 902 corporation no longer has any E&P at the time the related income is taken into account.[65]

> Example 6: U.S. corporation P owns all the stock of foreign corporation CFC1, which in turn has a wholly-owned foreign subsidiary CFC2, which is a reverse hybrid treated as a corporation for U.S. tax purposes and a pass-through entity for foreign tax purposes. In Year 1, CFC2 has 100 in E&P on which CFC1 pays 30 in foreign taxes. CFC1 also has its own operations which generate 50 in E&P, which it distributes on a current basis to P. In Year 2, CFC2 makes a loan of 100 to P, which P includes in income under Section 956; CFC1 has no other E&P.

The tax paid in Year 1 by CFC1 on CFC2's income is subject to Section 909 and thus cannot be claimed as a credit by P in Year 1. CFC1 is entitled to take the tax into account in Year 2 when the related income is taken into account by P as a result of CFC2's Section 956 investment. However, since CFC1 itself does not include the related income in its E&P and has no other E&P remaining, it is unclear how P can be in a position to claim the indirect credit, even though there is nothing in the policy of Section 909 that requires further deferral of the credit. It therefore may be appropriate to provide that the U.S. taxpayer can take the foreign tax into account when it recognizes the related income.[66]

b. Ordering Rules in "Mixed Income" Situations

More complicated issues arise where the covered person has E&P other than the E&P which gives rise to the tax in question. Ordering rules are required to determine the extent

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65. The Section 909 regime makes this scenario more likely than under prior law because of the possibility that the payor of the foreign tax will have distributed all its E&P prior to the related income being taken into account. Under Section 909, it appears that the foreign tax would not move along with the E&P as it does under prior law.

66. Under one approach, the E&P of the Section 902 corporation that paid the foreign tax would be reduced by the amount of the tax, which would not enter the corporation's foreign tax pool. Alternatively, for foreign tax credit purposes, the related income could be deemed for foreign tax credit purposes to have been distributed first by the covered person to the payor of the tax, and then from the payor to the U.S. taxpayer. This generally would result in the credit being determined by reference to the payor's overall foreign tax rate.

to which recognized or distributed E&P is deemed to be paid out of the related income associated with the tax paid in the Splitting Event.

> Example 7: Assume that U.S. corporation P owns all the stock of foreign entity FS, which is treated as a foreign corporation for U.S. and Country X tax purposes and a pass-through for Country Y tax purposes. Assume further that in Year 1 FS has 100 in pre-tax Country X E&P on which it pays 50 in Country X tax and 100 in pre-tax Country Y E&P on which P pays 20 in Country Y tax. FS has no earnings in Year 2. FS pays a dividend of 120 to P at the beginning of Year 2, leaving 30 of unremitted E&P.

We believe that there are at least four possible ordering methodologies. One possibility (the "Related Income E&P First Method") is to treat distributions (including deemed distributions) of the covered person's E&P as coming first from the E&P associated with the related income. Under this method, the dividend paid by FS to P would be treated as coming first out of the 100 in Country Y "related income," entitling P to claim the full credit for its Country Y taxes. The remaining 20 would be treated as paid out of FS's Country X E&P and would carry with it a Section 902 credit of 20.[67] A second possibility (the "Proportional Method") is to treat distributions as coming proportionally out of the E&P associated with the related income and the covered person's other E&P. Under the Proportional Method, the dividend would be treated as paid proportionally out of FS's Country X E&P of 50 (which reflects a reduction for the FS-level Country X tax) and its Country Y E&P of 100. Since only 80 of the dividend (*i.e.*, 80% of FS's Country Y E&P) would be paid out of Country Y E&P, P would be entitled to a credit of 16 of its taxes paid to Country Y (*i.e.*, 80% of FS's Country Y foreign taxes); P would be treated as receiving a dividend of 40 (80 after the Section 78 gross-up) out of FS's Country X E&P with a Section 902 credit of 40. A third possibility (the "Related

67. Only distributions out of the "other" E&P would carry with them credits for the covered person's own foreign taxes.

Income E&P Last Method") would be to treat distributions as coming from the related income E&P only after all the other E&P has been distributed. A fourth possibility (the "Tracing Method") would be to trace the source of distributions of E&P.

We generally do not recommend use of the Tracing Method. Tracing rules are difficult to administer and subject to taxpayer manipulation. We do, however, believe that in situations involving hybrid instruments, it makes sense to provide that income inclusions resulting from distributions on or sale of the hybrid instrument are appropriate times for treating the related income as being taken into account by the payor of the foreign tax.

The Related Income E&P Last Method maximizes the delay in "bringing together" the foreign tax and related income and may increase the likelihood that the entity that pays the foreign tax and the covered person will become unaffiliated prior to taking the foreign taxes into account with the attendant difficulties discussed at V.B.4, below. Although this method may act as an incremental deterrent to engaging in Splitting Events, such incremental disincentive – especially where the result is permanent denial of the credit – seems to be beyond what is contemplated by the statute.

Of the two remaining methods, it can be argued that the Related Income E&P First Method is preferable because it generally results in the income and foreign tax associated with the Splitting Event being brought together more quickly. This reduces administrative complexity for the Service and the taxpayer by reducing the delay in the U.S. taxpayer's ability to credit or deduct the foreign taxes beyond what is required by the policy of Section 909. In addition, it reduces the likelihood of encountering the issues discussed at V.B.4, below. However, we believe that the Proportional Method is preferable, primarily because it is more consistent with the general scheme of Section 902. In addition, the Related Income E&P First

Method is potentially more susceptible to taxpayer manipulation, although which method maximizes the foreign tax credit in a particular situation will depend on the relative rates of foreign tax on the covered person's related income and other income.

c. Effect of Covered Person Losses

If the covered person has a loss for a year, it may have insufficient E&P for the U.S. taxpayer or Section 902 corporation that paid the foreign tax to take into account the full original amount of the related income. Where the loss is properly taken into account as part of the tax base of the same country that imposed the foreign tax giving rise to the Splitting Event, taking into account the full amount of net E&P should suffice to permit the entire foreign tax to be taken into account.[68] In contrast, where the covered person's E&P related to the Splitting Event is reduced by E&P deficits incurred in another country, it can be argued that the U.S. taxpayer has effectively avoided U.S. tax on the related income, and that it therefore is appropriate to deny full credit or deduction of the foreign tax. We believe that there is a stronger argument that this is no different from a situation in which a Section 902 corporation pays tax in one jurisdiction and (prior to the distribution of the income or its inclusion under section 951) incurs a loss in another jurisdiction in a non-Splitting Event context, in which case the foreign taxes ultimately are fully creditable as long as there is some remaining net positive accumulated E&P to distribute. This situation could be addressed by providing that the amount of related income taken into account for purposes of section 909 is deemed to be equal to the greater of (i) the amount of the distribution from E&P that is attributable to related income or (ii) if related

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68. Where the loss can be applied as a carryover or carryback to reduce the payor's foreign tax liability, it is a straightforward matter to treat the loss as reducing related income.

income exceeds total E&P, the amount of the distribution multiplied by a fraction, the numerator of which is total related income and the denominator of which is total E&P.[69]

4. Disaffiliation of Entity Paying Foreign Tax and Covered Person

Further complications arise where, as a result of a change in the relationships of the relevant parties, the U.S. taxpayer or Section 902 corporation that paid or accrued the foreign tax will never take the related income into account. As an example of a situation in which this issue can arise, the JCT Report suggests that guidance can address situations where the person who pays or accrues the foreign tax or the covered person is liquidated.[70] Other situations in which this issue can arise include a sale of an interest by a U.S. taxpayer in a covered person in which the gain is insufficient to recognize the full amount of the covered person's E&P under Section 1248 and an issuance of new equity by a covered person that dilutes the interest of the person who paid or accrued the tax in the E&P associated with the related income.

Where the payor of the foreign tax or the covered person is liquidated or otherwise ceases to exist in a Section 381 transaction, it is appropriate for the successor to succeed to the transferor's position for purposes of Section 909. In other situations where the relationship between the parties is not preserved (including non-Section 381 liquidations as well as sale transactions), we believe that some form of relief should be permitted to take into account the fact that the U.S. taxpayer or Section 902 corporation did in fact bear the burden of the foreign tax. One possibility would be to permit an election to take the full amount of the related income and foreign tax into account (or, in the case of a dilution event, the portion of the related

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69. Sourcing of distributions is discussed at V.B.3.b, above.

70. JCT Report at 6. The JCT Report, however, does not provide any substantive direction as to how this situation should be addressed.

income and foreign tax that otherwise would never be taken into account). The related income could then be added to the basis of the interest in the covered person. In the case of a sale of a CFC where the Section 1248 amount would be less than the seller's share of the covered person's E&P, the effect would be to have an enhanced ordinary income inclusion and an offsetting capital loss.

C. Interplay of Section 909 and Proposed Legal Liability Regulations

The enactment of Section 909 arguably makes the Proposed Legal Liability Regulations unnecessary. Most of the situations that Treasury and the IRS sought to address under the Proposed Legal Liability Regulations are Splitting Events subject to Section 909 absent applicability of those regulations.

The enactment of Section 909 does not, however, preclude the government from proceeding with finalizing the Proposed Legal Liability Regulations, subject to any modification that may be appropriate, including with respect to the allocation of taxes among group members.[71] Section 909 does not in any way limit the government's authority (to the extent it existed in 2006) to redefine or "clarify" the determination of what taxpayer is liable for a foreign income tax.

In fact, we think that there is a strong case to be made for proceeding with finalization of the Proposed Legal Liability Regulations. In many if not most cases, determining the person with legal liability for the foreign taxes in accordance with the Proposed Legal Liability Regulations would result in the entity that would be the covered person under Section

71. *See* V.B.2, above.

909 being treated as legally liable for the foreign taxes. As a result, a transaction that otherwise would be a Splitting Event would not be a Splitting Event.

Applying the Proposed Legal Liability Regulations instead of Section 909 would have significant advantages in terms of administrability. The timing of foreign tax credits would be subject to the familiar rules of Section 902, and the substantial difficulties discussed above in cases involving mixed E&P and changes in ownership would be avoided. The case for applying the Proposed Legal Liability Regulations is especially strong in situations involving combined returns. In such cases, the Proposed Legal Liability Regulations simply reach the same result in situations where only the parent is liable for the taxes as would apply under the current Technical Taxpayer Rule if the group members were jointly and severally liable. It does not seem appropriate to have the joint and several liability question determine whether the Technical Taxpayer Rule or Section 909 applies, nor is it productive to have protracted disputes (such as those that occurred in *Guardian Industries*) between the Service and taxpayers as to whether foreign law does or does not provide for joint and several liability.

Although we understand that some taxpayers have asserted that the Proposed Legal Liability Regulations exceed Treasury's authority, we continue to believe, for the reasons set forth in the 2005 NYSBA Report, that those regulations are valid.[72] In any event, following enactment of Section 909, there would seem to be a much reduced practical risk of a challenge to the Proposed Legal Liability Regulations if they were finalized. A "successful" challenge would subject the "winning" taxpayer to Section 909 and therefore would most likely be a pyrrhic victory. Only taxpayers who want Section 909 would have any incentive to challenge the

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72. The 2005 NYSBA Report cited Sections 482 and 7805(b) as authority for its suggested revisions to the Technical Taxpayer Rule, which are in many respects similar to the Proposed Legal Liability Regulations.

regulations. Admittedly, the arguments against validity are probably stronger with respect to reverse hybrid entities than with respect to combined returns. Treasury and the Service could consider finalizing the Proposed Legal Liability Regulations in a manner that is limited to combined returns.

In suggesting that taxpayers be permitted to apply the Proposed Legal Liability Regulations, we do not mean to suggest that Section 909 be effectively eliminated. To the extent that the scope of Section 909 is broader in terms of the range of transactions covered (*e.g.*, in cases involving hybrid instruments), Section 909 would fully apply.

We also acknowledge that there may be situations in which the application of the Proposed Legal Liability Regulations produces inappropriate results. For example, if a reverse hybrid entity is owned by a foreign person and subsequently acquired by a U.S. corporation, treating foreign taxes paid by the former foreign owner as paid by the reverse hybrid with the result that the new U.S. owner can claim Section 902 credits when pre-acquisition earnings are distributed does not appear to be appropriate.[73] The Proposed Legal Liability Regulations could be modified to prevent U.S. persons from claiming credits for foreign taxes paid by foreign owners.

Finally, pending finalization of guidance with respect to Section 909 and the Proposed Legal Liability Regulations, we believe that it would be appropriate for the government

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73. However, one could argue that it is equally inappropriate to tax the new U.S. owner on pre-acquisition earnings that the U.S. owner in effect paid for. In addition, where a U.S. person buys the stock of a non-hybrid entity from a foreign person without making a Section 338 election, the same results -- *i.e.*, taxation of the new owner on pre-acquisition E&P and allowance of credit for pre-acquisition foreign taxes, the economic benefit and burden of which was borne by the prior owner -- apply. In any event, it is clearly inappropriate to attribute foreign taxes paid by a foreign owner of a reverse hybrid in a jurisdiction other than that of the reverse hybrid. For example, if a Country X resident owns an interest in a Country Y reverse hybrid that does not do business in Country X, Country X residence based taxes paid by the Country X resident owner on its share of the Country Y company's income should not be attributed to the reverse hybrid.

to issue a notice permitting taxpayers to rely on the Proposed Legal Liability Regulations, subject to modification along the lines discussed above, as an interim matter.

D. Effective Date Issues

The effective date of Section 909 poses significant issues for taxpayers. Section 211(c)(1) of the Act provides that Section 909 applies to foreign income taxes paid or accrued in taxable years beginning after December 31, 2010. Section 211(c)(2) of the Act provides that Section 909 also applies to foreign income taxes paid or accrued by Section 902 corporations in taxable years beginning on or before December 31, 2010 for purposes of applying Sections 902 and 960 to taxable years beginning after such date.

The application of Section 909 to taxes paid or accrued by Section 902 corporations prior to the effective date poses both administrative and substantive concerns. From an administrative standpoint, U.S. taxpayers are faced with an imminent decision as to whether to repatriate earnings from foreign subsidiaries prior to December 31, 2010 in order to avoid the possible application of Section 909 to a later repatriation of pre-2011 earnings. The difficulty of this decision is greatly exacerbated by uncertainty as to how Section 909 will actually work. Accordingly, we think that prompt interim guidance is needed so that taxpayers can make reasonably informed decisions.

From a substantive standpoint, Section 211(c)(2) of the Act requires an examination that potentially goes back many years in order to determine whether Section 902 corporations engaged in Splitting Events. In fact, it appears that foreign taxes paid in years prior to Section 902 corporations having any U.S. owners (much less controlling U.S. owners) may be implicated.

Taxpayers will have to determine whether pre-2011 taxes paid or accrued in connection with Splitting Events were previously claimed as credits under Section 902 or

Section 960.[74] It will also be necessary to trace whether a covered person's related income has been distributed to the U.S. taxpayer or taken into account by the entity that paid the tax prior to the effective date (in which case Section 909 should not apply) or otherwise been distributed to another foreign affiliate.[75]

In order to alleviate the burden of making determinations under Section 909, we believe that simplified rules should be provided for pre-2011 foreign taxes. In particular, we recommend that Splitting Events for foreign taxes paid in such years should be limited to situations involving combined returns, reverse hybrid entities, or hybrid instruments similar to that described in the JCT Report example, as well as abusive situations.

In addition, if, as of the end of the last taxable year beginning prior to January 1, 2011, the entity that paid or accrued the foreign taxes is no longer in a covered person relationship with the covered person that earned the related income, Section 909 should not apply. Denial of the credit seems overly harsh in such situations.

Aside from facilitating decisions as to whether to repatriate income prior to the end of 2010, simplified rules for pre-2011 foreign taxes have the further benefit of facilitating financial reporting for taxpayers with undistributed foreign income.

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74. A literal reading of Section 211(c)(2) of the Act suggests that Section 909 applies to post-2010 distributions of pre-2011 earnings as if Section 909 had always been in effect. This could result in a pre-2011 foreign tax being taken into account under Section 902 or Section 960 in a post-effective date year, even if it has already been taken into account under prior law in a prior year. Guidance should make clear that such double crediting is not permitted.

75. In this regard, the Proportional Method described at V.B.3.b, above, is probably easier to apply than other possible methods because it is more consistent with the operation of prior law.