NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

TEMPORARY AND PROPOSED
"SPLITTER" REGULATIONS

AND

FINAL TECHNICAL TAXPAYER REGULATIONS

October 2, 2012

TABLE OF CONTENTS

Report No. 1273

New York State Bar Association Tax Section

Report on Temporary and Proposed "Splitter" Regulations
and
Final Technical Taxpayer Regulations

I. Introduction

This report[1] comments on the proposed[2] and temporary[3] regulations under Section 909 of the Internal Revenue Code of 1986, as amended[4] (the "**Splitter Regulations**") and the final regulations under Section 901 (the "**Technical Taxpayer Regulations**"),[5] both released by the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**IRS**") on February 14, 2012.[6] The Splitter Regulations set forth an exclusive list of transactions and other arrangements treated as "foreign tax credit splitting events" under Section 909. The Technical Taxpayer Regulations finalized certain portions of proposed regulations addressing the allocation of creditable foreign income taxes ("**foreign taxes**") among members of a foreign consolidated group (the "**Proposed Legal Liability Regulations**")[7].

The Technical Taxpayer Regulations allocate the obligation to pay foreign taxes of a combined group among the members in proportion to their share of the foreign tax base, regardless of whether the members of the group have joint and several liability and regardless of which member actually pays the foreign tax. By doing so, they greatly restrict the ability to

---

1 The principal authors of this report are David R. Hardy and Ansgar A. Simon. Significant contributions were made by Kimberly S. Blanchard, Peter J. Connors, Joshua Gordon and Andrew W. Needham. Helpful comments were received from Richard Anderson, Andrew H. Braiterman, Kevin Colan, Abraham Leitner, Aliza Levine, Yaron Z. Reich, Paul Seraganian, Michael L. Schler and Stephen E. Shay. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

2 Notice of Proposed Rulemaking, REG-132736-11, 77 Fed. Reg. 8,184 (Feb. 14, 2012).

3 T.D. 9577, 2012-15 I.R.B. 730.

4 Hereinafter referred to as the "Code". All section references refer to the Code or the Treasury regulations issued thereunder.

5 T.D. 9576, 2012-15 I.R.B. 723.

6 We have previously commented on Section 909 in New York State Bar Association Tax Section Report No. 1223, *Issues Under Section 909 of the Code* (Nov. 8, 2010) (the "**Section 909 Report**") and in New York State Bar Association Tax Section Report No. 1249, *The Interaction of Section 909 and Subchapter K* (November 29, 2011) (the "**Partnership Section 909 Report**"), both available at http://www.nysba.org.

7 Notice of Proposed Rulemaking, REG-124152-06, 71 Fed. Reg. 44,240 (Aug. 4, 2006).

exploit the combined reporting rules of a foreign jurisdiction to split foreign taxes from the related income. For other arrangements that split foreign taxes from the related income ("**Splitter Arrangements**"), the Technical Taxpayer Regulations cede jurisdiction to Section 909 and the Splitter Regulations.

The Splitter Regulations suspend the foreign tax credit for U.S. federal income tax purposes **("U.S. tax purposes")** for foreign taxes paid or accrued in connection with a Splitting Arrangement. Such taxes become creditable only when the related income is reunited with or otherwise recognized by the taxpayer for U.S. tax purposes.

Part II of this report describes some of the relevant background to the foreign tax credit rules, tracing the evolution of the technical taxpayer rule and the related shortcomings of the rule that led to the enactment of Section 909. Part III of this report summarizes the Technical Taxpayer Regulations and the Splitter Regulations. Part IV of this report summarizes our recommendations under both sets of regulations. Part V of this report discusses the reasons for our recommendations.

II. Historic Background

A. A Brief Summary of the Foreign Tax Credit Regime

As described in our Section 909 Report, the purpose of the foreign tax credit is to mitigate the double taxation of foreign source income, which can occur when the same income is subject to tax in two different countries. By allowing a foreign tax credit, the United States cedes primary taxing jurisdiction over foreign source income to the source country. Consistent with this purpose, the credit is limited to the portion of the U.S. tax attributable to such income. Under Section 904(d), separate tax credit limitations apply to different categories of foreign source income. Within each category, the foreign tax credit is limited to the product of the overall U.S. tax liability of the taxpayer before any credits and a fraction equal to the foreign source taxable income within such category divided by the taxpayer's worldwide taxable income.[8] The foreign tax credit is therefore limited to the amount of U.S. tax that would have been imposed on the taxpayer's foreign source taxable income of the same character (the "**foreign tax credit limitation**"). The purpose of the foreign tax credit limitation is to protect

[8] A U.S. taxpayer is in an "excess limitation" position for any category of income for which its actual creditable foreign income tax is less than this formula and is in an "excess credit" position for any category of income for which its actual creditable foreign income tax is greater than this formula.

the U.S. tax base by permitting a foreign tax credit only to the extent necessary to prevent or mitigate double taxation.

The taxpayer entitled to the credit is the person who is legally liable for the tax under foreign law.[9] The United States generally relies on foreign law to determine which entity is legal liability for the tax and on its own laws to determine the U.S. tax consequences.[10] In certain cases, the identity of the entity that is legally liable for the tax is not entirely clear, as, for example, in the case of a foreign combined group where the common parent entity is responsible for the payment of the entire tax liability of the group. When it is, it is often not clear whether the parent is acting as a mere collection agent on behalf of the other group members or is instead treated as "owning" the income of its various members. In the case of a foreign partnership, the courts and the IRS have ruled that the foreign tax is imposed at the partner level for U.S. and foreign purposes, which allows the U.S. partners to claim the foreign tax credit.[11] Since the 1970s, however, Treasury and the IRS have struggled to apply the foreign tax credit rules to foreign legal entities treated as either branches or partnerships under foreign tax law but as separate corporations under U.S. tax law ("**reverse hybrids**").[12]

B. The Evolution (and Limitations) of the Technical Taxpayer Rule

The technical taxpayer rule under Treasury Regulations § 1.901-2(f) provides that "[t]he person by whom tax is considered paid for purposes of Sections 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." It therefore starts with the proposition that the technical taxpayer is the person on whom foreign law imposes legal liability for the foreign tax,[13] adopting the rule announced by *Biddle* in the 1930s. As among members of a foreign

9 *See Biddle v. Comm'r*, 302 U.S. 573 (1938) (hereinafter, "***Biddle***"); Rev. Rul. 58-518, 1958-2 C.B. 381.

10 *See* Yaron Reich, "International Arbitrage Transactions Involving Creditable Taxes," 85 Taxes 53, at 62 (March 2007); Phil West, "Foreign Law in U.S. International Taxation: The Search for Standards," 3 Florida Tax Review 147 (1996).

11 *See Arundel Corp. v. Comm'r*, 102 F. Supp. 1019 (CT. Cl. 1952); Rev. Rul. 71-141, 1971-1 C.B. 211.

12 The IRS has ruled that the U.S. owners of a U.S. unincorporated association, disregarded by the foreign country where it operated but treated as a corporation for U.S. tax purposes, were legally liable for the foreign tax imposed on the income of the entity. *See* Rev. Rul. 72-197, 72-1 C.B. 215. Previously in *Abbot Labs. Int'l Co. v. United States*, 160 F. Supp. 321 (N.D. Ill. 1958), *aff'd*, 267 F.2d 940 (7th Cir. 1959) (hereinafter, "***Abbot Labs***"), a court reached the opposite result by holding that U.S. owners of an Argentine business entity treated as a partnership for foreign tax purposes but as a corporation for U.S. tax purposes were not eligible for the foreign tax credit for foreign taxes paid on the income that belonged to the entity. Treasury appears to have disregarded this holding on the basis that the case was inconsistent with *Biddle*.

13 *See* Regs. § 1.901-2(f)(3) (as in effect before the Technical Taxpayer Regulations became final).

consolidated group, the rules at that time had provided that the legal liability was borne in proportion to each member's share of the foreign tax base, but only if the member was jointly and severally liable for the foreign tax. This aspect of the basic technical taxpayer rule was deficient in several respects. Perhaps the greatest deficiency of the rule is that it allowed taxpayers that had not yet reported the related income to "cross credit" the tax against unrelated foreign source income. This type of "splitting" was most likely to be available in the case of hybrids and reverse hybrids. The case of *Guardian Industries* is a textbook example.

In *Guardian Industries Corp. v. Comm'r,*[14], a U.S. group established a Luxembourg *société à responsabilité limitée* (the "**SARL**") as the parent company of its Luxembourg subsidiaries. Under Luxembourg law, the SARL and its subsidiaries filed Luxembourg income tax returns as a single "fiscal unity." Although the SARL reported the income of the subsidiaries, the SARL alone was legally liable for the Luxembourg tax.[15] For U.S. tax purposes, the SARL was a disregarded entity and each of the operating subsidiaries was a controlled foreign corporation. Because the Luxembourg tax of the fiscal unity was legally imposed on the SARL, the court treated the tax as incurred directly by the U.S. group. The U.S. group claimed a credit under Section 901 for the foreign taxes paid by the SARL even though it had yet to report the income of its subsidiaries. The U.S. group was therefore able to shelter unrelated foreign source income from residual U.S. taxation by cross-crediting the foreign taxes of the SARL.

In 2006, in response to *Guardian Industries* and other court decisions, Treasury issued the Proposed Legal Liability Regulations.[16] These regulations proposed to allocate the foreign tax among combined income entities in proportion to their share of the foreign tax base regardless of which entities were legally required to pay the tax. Where the U.S. owner of a reverse hybrid was liable for foreign tax but the foreign income was not taxed in the United States, the foreign tax would have been allocated to the reverse hybrid. The Proposed Legal Liability Regulations also included a general definition of legal liability: "[i]n general, foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes."

---

14 65 Fed. Cl. 50, 2005-1 U.S.T.C. ¶50, 263, *aff'd*, 477 F.3d 1368 (Fed. Cir. 2007) (hereinafter, "***Guardian Industries***").

15 Specifically, the Federal Claims Court found that Luxembourg law did not impose joint and several liability for tax on the subsidiaries in the fiscal unity, making apportionment of the tax under Treasury Regulations § 1.901-2(f)(3) unavailable.

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

In 2007, Treasury and the IRS published a proposal to amend the non-compulsory payment regulations of Treasury Regulations § 1.901-2(e)(5)(iii) (the "**2007 Proposed Regulations**"), which included rules for allocating foreign tax among members of a "group relief" combination.[17] The 2007 Proposed Regulations clarified that in the context of a group of foreign corporations, all of which are 80 percent owned, directly or indirectly, by a domestic 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 the foreign tax credit.[18] The 2007 Proposed Regulations have not been promulgated in final form.

III. The Technical Taxpayer Regulations and the Splitter Regulations

A. The Technical Taxpayer Regulations

The Technical Taxpayer Regulations did not adopt the definition of legal liability for foreign income tax of the Proposed Legal Liability Regulations. The preamble to the final regulations stated that Treasury and the IRS "are continuing to consider whether and to what extent to revise and clarify the general rule that tax is considered paid by the person who has legal liability under foreign law for the tax …[including] a special rule for determining who has legal liability in the case of a withholding tax imposed on an amount of income that is considered received by different persons for U.S. and foreign tax purposes, as in the case of certain sale-repurchase transactions."[19]

The Technical Taxpayer Regulations adopted, with minor modifications, the rules of the Proposed Legal Liability Regulations regarding the apportionment of foreign taxes among persons that report income on a combined basis under foreign law. Under these rules, foreign taxes are apportioned on a pro-rata basis in proportion to each person's allocable share of the combined income, as determined under foreign tax law. Consistent with the Proposed Legal Liability Regulations, these rules generally eliminate the requirement of joint and several liability. Because the primary focus of the Technical Taxpayer Regulations is combined

17 REG-156779-06, 72 Fed. Regs. 15,081 (March 30, 2007).

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

19 The preamble to the Proposed Legal Liability Regulations had included a request for comments on whether the regulations should provide a special rule on where legal liability resides in the case of withholding taxes imposed on an amount received by one person on behalf of the beneficial owner of such amount, specifically citing nominee arrangements.

income and partnership structures, they cede the regulation of reverse hybrids and hybrid instruments that separate foreign taxes from the related income to Section 909.

In the case of partnerships and disregarded entities, Treasury Regulations § 1.901-2(f)(4) provides that foreign taxes imposed at the entity level on a partnership for U.S. tax purposes are first determined to be a legal liability of such entity and then allocated to the partners under Section 704(b) of the Code and the regulations thereunder and that foreign taxes imposed at the entity level on an entity that is disregarded for U.S. tax purposes are treated as the legal liability of its U.S. owner.

The Technical Taxpayer Regulations are generally effective for foreign taxes paid or accrued in taxable years beginning after February 14, 2012. The IRS expressed its belief that under current law, the person who paid or accrued foreign taxes during a pre-effective date year (as determined under prior law) is the person eligible under Section 904(c) to carry forward such taxes to a post-effective date year, notwithstanding that such person may not be considered the technical taxpayer if it had paid or accrued the foreign taxes in the post-effective date carryover year. The IRS also expressed its belief that the person who paid or accrued foreign taxes in a post-effective date year (as determined under the Technical Taxpayer Regulations) is the person eligible under Section 904(c) to carry back such taxes to the last pre-effective date year. Further, these regulations permit taxpayers to apply the combined income rules to taxable years beginning after December 31, 2010 and on or before February 14, 2012. Under Notice 2010-92, [20]but not under the Splitter Regulations, to the extent that a taxpayer did not allocate foreign consolidated tax liability among the members of a foreign consolidated group based on each member's share of the consolidated taxable income included in the foreign tax base under the principles of Treasury Regulations § 1.901-2(f)(3), the allocation is treated as a pre-2011 Splitting Event (as defined below) under Section 909. To prevent the treatment of more than one person as the payor of the relevant foreign tax, Treasury Regulations § 1.901-2(f)(4) will not apply to any amount of foreign tax paid or accrued in a post-effective date year of any person if such tax would be treated as paid or accrued by a different person in a pre-effective date year under the prior regulations.

B. The Splitter Regulations

Section 909 requires that foreign taxes that are paid or accrued by a U.S. taxpayer but separated from their related income ("**Split Taxes**," and such separation, a "**Splitting Event**")

[20] 2010-52 I.R.B. 916.

may not be taken into account until the taxpayer takes into account the related income for U.S. tax purposes. In addition, in the case of a foreign corporation described in Section 902 ("**Section 902 Corporation)**,"[21] the separation of Split Taxes from related income results in a suspension of the Split Taxes paid or accrued by the Section 902 Corporation for purposes of Sections 902 or Section 960 and for purposes of determining earnings and profits under Section 964(a) until the Section 902 Corporation or its U.S. corporate shareholder (or member of such shareholder's consolidated group) takes the related income into account.

A Splitting Event is defined as an event with respect to a foreign tax if the related income (giving rise to the payment of a foreign tax) is or will be taken into account by a "covered person." Section 909 defines a covered person as an "entity" in which the payor (of the foreign tax) holds, directly or indirectly, at least a 10 percent ownership interest, any "person" that holds, directly or indirectly, a least a 10 percent ownership interest in the payor, or a related person within the meaning of Sections 267(b) or 707(b). In addition, Treasury and the IRS were given regulatory authority to expand the class of covered persons.

Section 909 applies to foreign taxes paid or accrued in taxable years beginning after December 31, 2010. However, for purposes of determining the indirect or deemed-paid foreign tax credit of an eligible U.S. corporate shareholder of a Section 902 Corporation or of a corporate U.S. shareholder of a controlled foreign corporation under Section 960 with respect to dividend distributions or inclusions under Section 951(a) after the effective date, Section 909 applies to foreign taxes paid or accrued before 2011 but recognized as a dividend in years beginning after December 31, 2010.

In December 2010, Treasury and the IRS issued Notice 2010-92 to provide guidance for determining pre-2011 Split Taxes and related income of Section 902 Corporations. Split Taxes arise in with respect to pre-2011 periods only for the following Splitter Arrangements: (1) reverse hybrid structures; (2) foreign consolidated groups "to the extent that the taxpayer did not allocate foreign consolidated tax liability based on each member's share of the foreign tax base"; (3) foreign group relief or other loss-sharing arrangements if (a) there is a foreign law debt instrument that is disregarded for U.S. tax purposes, (b) the owner of the instrument pays foreign income tax attributable to the instrument, and (c) the instrument gives rise to a deduction under foreign tax law; and (4) hybrid instruments that are treated as either debt or equity for foreign tax purposes and the opposite for U.S. tax purposes.

---

[21] A Section 902 Corporation is a foreign corporation with respect to which one or more domestic corporations meet the ownership requirements of Section 902. *See* Section 909(d)(5).

The Splitter Regulations take substantial direction from Notice 2010-92 by providing an exclusive list of Splitter Arrangements subject to Section 909.[22] The Splitter Regulations effectively follow the statutory language, stating that there is a Splitting Event with respect to foreign taxes paid or accrued if and only if, in connection with a Splitter Arrangement, the related income is taken into account for U.S. tax purposes by a covered person.[23] Treasury did not exercise its authority under Section 909(d)(4)(D) to expand the statutory definition of a "covered person" with respect to the payor of the foreign tax.

The four post-2010 Splitting Arrangements of the Splitter Regulations are somewhat broader than those identified in Notice 2010-92:

(1) "Reverse Hybrid Splitter Arrangements" are present when a payor pays or accrues foreign taxes with respect to income of a reverse hybrid.[24]

(2) "Loss-Sharing Splitter Arrangements" are present if, under a foreign group relief (or other loss-sharing) regime, a shared loss of a "U.S. combined income group" could have been used to offset income of that group but is instead used to offset income of another U.S. combined income group. The related income in a Loss-Sharing Splitter Arrangement is the amount of income offset by the usable shared loss.[25]

(3) "Hybrid Instrument Splitter Arrangements" are Splitter Arrangements involving a U.S. equity hybrid instrument (*i.e.*, an instrument treated as equity for U.S. tax purposes but debt for foreign tax purposes) or a U.S. debt hybrid instrument (*i.e.*, an instrument treated as debt for U.S. tax purposes but equity for foreign tax purposes such as a preferred stock repurchase obligation or "repo").

In the case of a U.S. equity hybrid instrument, a Splitter Arrangement is present if payments or accruals on or with respect to the instrument (1) give rise to foreign taxes paid or accrued for U.S. tax purposes by the owner of the instrument; (2) are deductible by the issuer for foreign tax purposes; and (3) do not give rise to income to the owner for U.S. tax purposes. For U.S. equity Hybrid Instrument Splitter Arrangements, the related income is an amount of income of the issuer equal to the deductible payment or accrual for foreign tax purposes.

---

22 Temp. Treas. Regs. § 1.909-0T through 6T. Temp. Treas. Regs. § 1.909-6T incorporates the provisions of Notice 2010-92 governing the definition of, and rules applicable to, pre-2011 Splitting Events.

23 Temp. Treas. Regs. § 1.909-2T(a)(1).

24 Temp. Treas. Regs. § 1.909-2T(b)(1).

25 Temp. Treas. Regs. § 1.909-2T(b)(2).

In the case of a U.S. debt hybrid instrument, a Splitter Arrangement is present if the issuer of the debt instrument pays or accrues foreign taxes on income for foreign tax purposes that effectively equals the payments or accruals of interest on the debt instrument, as those payments or accruals are non-deductible for foreign tax purposes, but are deductible for U.S. tax purposes. The related income in a U.S. debt Hybrid Instrument Splitter Arrangement is the interest income recognized for U.S. tax purposes but not for foreign tax purposes.[26]

(4) "Partnership Inter-Branch Payment Splitter Arrangements", which are present if and to the extent there is an inter-branch payment and the foreign tax paid or accrued with respect to such payment is not allocated to the partners in the same proportion as the underlying income of the partnership. An inter-branch payment is, as defined by reference to now-withdrawn Treasury Regulations § 1.704-1(b)(4)(viii)(*d*)(*3*) as in effect prior to April 1, 2011, a payment that one branch of a partnership receives from another branch of the same partnership. The related income in a Partnership Inter-Branch Payment Splitter Arrangement is the amount of income that is not in proportion to the foreign tax.[27]

This list of Splitter Arrangements is effective for foreign taxes paid or accrued in taxable years beginning on or after January 1, 2012.

Temporary Regulations § 1.909-3T incorporates the mechanics for suspension of Split Taxes and the determination and allocation of the related income. Related income for post-2010 years will be treated as distributed on a pro-rata basis with all other earnings and profits of such distributing person for purposes of determining whether related income has been recognized by the payor of any suspended Split Taxes or by a Section 902 shareholder. Similarly, if pre-2011 taxes of a Section 902 Corporation include both Split Taxes and non-Split taxes, taxes deemed paid under Section 902 or 960 will be deemed to have been paid on a pro-rata basis from Split Taxes and non-Split Taxes.[28]

---

26 Temp. Treas. Regs. § 1.909-2T(b)(3).

27 Temp. Treas. Regs. § 1.909-2T(b)(4).

28 Temp. Treas. Regs. § 1.901-6T(e))

IV. <u>Executive Summary and Recommendations</u>

A. General Observation

We commend Treasury and the IRS for finalizing the Technical Taxpayer Regulations in Treasury Regulations § 1.901-2(f)(3) and for limiting Splitter Arrangements to an exclusive list of transactions. Because the Technical Taxpayer Regulations allocate liability for the foreign tax in accordance with the rights of creditors under local law and therefore to the person that actually pays the foreign tax, we believe it should have conceptual primacy over the regulation of Splitter Events when effective in doing so. We also believe it will be much easier to administer than Section 909.

As at least one commentator has suggested, however, the technical taxpayer rule functions properly only when both the U.S. and foreign taxing jurisdictions treat the same entity as the "owner" of the related income.[29] When the two jurisdictions treat different entities as the owner, the technical taxpayer rule may facilitate the splitting of foreign taxes from the related income. We believe the Splitter Regulations should apply to these transactions.

The Section 909 regime envisioned by the Splitter Regulations involves complex monitoring and accounting that may not deliver the correct result in every instance. It is appropriate to recognize, therefore, that the consequences under the Splitter Regulations are potentially more harsh than those under the Technical Taxpayer Regulations. As described more fully below, the suspension of the foreign tax credit for Split Taxes under Section 909 may become permanent in many cases merely because affected taxpayers are not able to track the ultimate repatriation of the related income in accordance with the Splitter Regulations.

B. Specific Recommendations

The following is a summary of our comments and recommendations on the Technical Taxpayer Regulations:

(1) *Reinstate Definition of Legal Liability*. We recommend that Treasury and the IRS modify the Technical Taxpayer Regulations to restore the general definition of legal liability for tax under the Proposed Legal Liability Regulations.

(2) *Eliminate Combined Income Splitter*. We recommend that Treasury and the IRS eliminate the combined income splitter under Notice 2010-92 by permitting

[29] *See* Kimberly Blanchard, "Why § 909 was Enacted (Whether We Like It or Not)," 40 *Tax Mgmt. Int'l J.* 288 (2011).

taxpayers to elect to apply the Technical Taxpayer Regulations to any foreign taxes paid or accrued in taxable years beginning after December 31, 2010.

The following is a summary of our comments and recommendations on the Splitter Regulations:

(1) *Clarify Related Income Distribution Mechanics*. To reduce the risk of disallowance, we recommend that Treasury and the IRS provide more detailed rules regarding the tracing of related income, in particular with regard to the impact of intervening losses.

(2) *Loss-Sharing Splitter Arrangements: Definition of "Usable Shared Loss"*. We recommend that, with respect to Loss-Sharing Splitter Arrangements, Treasury and the IRS clarify whether a shared loss is deemed to be "usable" only in the taxable year it is incurred or whether it includes foregone carrybacks and/or carryforwards as well.

(3) *Loss-Sharing Splitter Arrangements: Related Income Determination*. We recommend that, in the case of Loss-Sharing Splitter Arrangements, related income should be treated as taken into account by netting losses shared among foreign subsidiaries in the same jurisdiction and, to the extent that the U.S. combined group that surrenders a loss has reduced its income for foreign tax purposes, by including a loss surrendered to such group.

(4) *Withdraw Prior Group Relief Regulations*. We recommend that Treasury and the IRS withdraw the 2007 Proposed Regulations.

(5) *Time of Covered Person Determination*. We recommend that Treasury and the IRS clarify that a covered person is any person that stands in the required relationship either at the time the Split Taxes were paid or accrued or at the time the related income was taken into account (or both).

(6) *Attribute Carryover for Successors and Consolidated Groups*. We recommend that Treasury and the IRS (i) expand the scope of Temporary Treasury Regulations § 1.909-6T(e)(3) to include a transferee Section 902 shareholder and (ii) clarify how and to what extent the principles that apply to pre-2011 Split Taxes of a Section 902 Corporation also apply to U.S. taxpayers in the case of a transfer of Split Taxes.

(7) *Inbound Liquidations and Asset Transfers.* We recommend that, upon the liquidation of a reverse hybrid or other covered person with related income, the portion of any Split Taxes that remain suspended due to intervening losses should be treated as having been contributed to and paid by the liquidating entity in reduction of its earnings and profits pool immediately before the liquidation.

(8) *Dispositions of the Covered Person or the Payor.* We recommend that final regulations allow a basis increase for any Split Taxes upon a sale or other disposition of a covered person that terminates the covered person relationship to the extent the Split Taxes would otherwise remain suspended after the sale.

(9) *Expand Covered Person Definition for U.S. Debt Hybrid Instrument Splitter Arrangements*. We recommend that Treasury consider expanding the definition of "covered person" for purposes of determining whether a U.S. debt hybrid instrument constitutes a Splitter Arrangement by treating (a) the hybrid instrument as an "ownership interest" and (b) if the hybrid instrument is issued by a partnership or disregarded entity for U.S. tax purposes, any other person that holds a 10 percent or greater interest in the entity as having a covered person relationship.

V. <u>Discussion of Recommendations</u>

A. The Technical Taxpayer Regulations

1. Reinstate Definition of Legal Liability

The Proposed Legal Liability Regulations provide for a general definition of legal liability for tax: "[i]n general, foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes." Because legal liability is a necessary foundational element for both Section 909 and the foreign tax credit rules generally, we believe a clear definition of the term is important. Since the rules in the Technical Taxpayer Regulations for allocating foreign taxes among members of a combined group and the rules for foreign tax credit allocations among partners of a partnership both rest on the principle of following their respective shares of the foreign tax base, we believe the definition in the Proposed Legal Liability Regulations is consistent with these rules. In addition, by allocating the legal liability for tax to the person required to recognize the income under local law, the U.S. tax determination is likely to be much more predictable.

Although we understand that a regulatory definition of legal liability for tax will not prevent all premature claims to the foreign tax credit, these claims tend to occur only when the U.S. and foreign tax jurisdictions treat different entities as the "owners" of the underlying income. Because Section 909 now applies to these hybrid arrangements, we do not believe a general definition of legal liability based upon entitlement to income is likely to facilitate these transactions.

2. Eliminate Combined Income Splitter

As described above, the Technical Taxpayer Regulations now allow foreign combined groups to allocate combined foreign taxes among their members in proportion to their respective shares of the foreign tax base, without regard to whether any member has joint and several liability. For taxpayers reporting Section 902 dividends in 2011 attributable to earnings in earlier years, Notice 2010-92 provided that taxpayers filing foreign combined returns that did not allocate foreign taxes in proportion to their respective shares of the foreign tax base would be subject to Section 909, requiring suspension of the foreign tax credit until the related income was reunited with the payor of the tax.

We do not believe it is appropriate to require a foreign combined group to report foreign taxes for a single year as Split Taxes when the foreign taxes of the group were allocated under the technical taxpayer rule as it then applied both before and after such year. We believe it would be more sensible to allow such taxpayers to elect to treat foreign taxes on foreign combined income as allocated in proportion to the foreign tax base for pre-2011 Split Taxes, effectively allowing them to elect out of the Splitter Regulations.

B. The Splitter Regulations

We support the targeted approach of the Splitter Regulations, which set forth an exclusive list of transactions subject to Section 909. Given the wide range of transactions and other arrangements within the potential ambit of the statute, we believe this approach will reduce much of the uncertainty regarding the scope of Section 909 and the related cost of compliance for many taxpayers. We also agree with the following additional choices:[30]

- to ignore timing and base differences between U.S. and foreign law in the determination of income subject to tax of a foreign entity as potential Splitting Events;
- to ignore transfer pricing adjustments as potential Splitting Events;
- to allow the successor in a Section 381 transaction or a transaction subject to Treasury Regulations § 1.367(b)-7 to succeed to the transferor's related income or Split Taxes, as applicable, under Section 909; and
- to apply the definitions of "Splitting Event" and "Splitter Arrangement" only on a prospective basis.

We also generally agree with the decision not to extend "covered person" status to unrelated persons (except with respect to U.S. debt Hybrid Instrument Splitter Arrangements, as discussed below).

[30] On these matters, the Splitter Regulations generally are consistent with our proposals in the Section 909 Report and the Partnership Section 909 Report.

1. Clarify Related Income Distribution Mechanics

The central mechanism for application of the Section 909 suspension regime is, first, to allocate the tax payment or accruals in accordance with the technical taxpayer rule and, second, to suspend the foreign tax credit for such tax payments or accruals until the related income recognized by a covered person is either reunited with the technical taxpayer or recognized by a U.S. shareholder of a Section 902 Corporation (or a member of the same consolidated group). For purposes of this regime, the allocation of the tax payment is the easier of the two elements to monitor. However, as described above, where foreign law creates an incentive tax rate for particular types of income, the taxes paid must be allocated separately among foreign combined group members in proportion to the relative amounts of such income.[31] For the covered person, this will create a corresponding obligation to track and monitor the preferential category of income because it is this income which must be reunited with the Split Taxes to lift the suspension of the foreign tax credit.

For many U.S.-based multinationals, the mechanics of tracking these categories of related income under Temporary Regulations § 1.909-3T can become very complex, in particular when imposed on the internal tax personnel of the foreign affiliates. To the extent these tracking mechanics cannot be observed, affected taxpayers will be unable to sustain their burden of proof to establish that the related income has in fact been repatriated for U.S. tax purposes.

The starting point for tracking related income of a covered person are the general provisions of Section 902 for tracking and repatriating the earnings and profits of foreign affiliates. Under Treasury Regulation § 1.902-1(b), foreign subsidiaries are required to maintain their earnings and profits for post-1986 years under U.S. methods for foreign assets, which usually involve alternative depreciable lives and starting tax bases for such assets. The subsidiaries are then treated as distributing the deemed payment of foreign taxes in proportion to the distributions of their post-1986 earnings and profits.

In this context, Temporary Regulations § 1.909-3T(a) provides that the principles of Temporary Regulations § 1.909-6T(d)-(f) apply to the monitoring of related income and Split Taxes in years beginning on or after January 1, 2011. Temporary Regulations § 1.909-6T(d) states that the earnings and profits of the covered person must be maintained each year and that distributions from such earnings and profits must be treated as related income in proportion to

[31] Treas. Regs. § 1.901-2(f)(3)(i).

the amount of such income relative to all other categories of income. Treasury Regulations § 1.909-6T(c) requires the covered person and the taxpayer to annually adjust their income and taxes, and segregate each separate category of earnings for foreign tax credit limitation purposes as defined in Treasury Regulations § 1.904-4(m) (generally to foreign tax credit baskets). While current law has only two foreign tax credit baskets, the general limitation basket and the passive income basket, the law in effect for calendar year 2006 and before had multiple baskets, including separate baskets for financial services income, high withholding tax income, shipping income and other categories depending on the particular year. The covered person must then make annual adjustments to its earnings and profits (or related income) to reflect its income and expense in subsequent years. And just as the Section 902 regulations provide that there can be no dividend from a corporation with a negative earnings account, there can be no distribution of related income from such a corporation under Section 909.

For any post-2010 distribution, the related income will emerge on a pro-rata basis with earnings from each of the other categories described above (to the extent applicable). When the covered person is a participant in a Loss-Sharing Splitter Arrangement or a Hybrid Instrument Splitter Arrangement, the covered person does not actually receive income from the technical taxpayer but rather an entitlement to a deduction, which it must treat as related income because it reduces the foreign income of the covered person. Such deduction would then presumably reduce the foreign income of the covered person in each of the foregoing separately tracked categories on a pro-rata basis.

The obligation under the Splitter Regulations to reconstruct earnings and profits and foreign tax pools back to 1997 is likely to present compliance challenges to many taxpayers that engaged in pre-2011 Splitter Arrangements. For those taxpayers unable to comply with the tracing of related income that the suspension regime of Section 909 envisions, the suspension rule of Section 909 will become a de facto disallowance rule. Although we acknowledge these requirements are not new to the Code, they will have the effect of expanding the accounting complexity and prolonging the monitoring period for determining when related income has been reunited with the payor.

To ensure that Section 909 operates only to suspend the foreign tax credit in most cases, we urge Treasury to provide further guidance relating to tracing the repatriation of related income. Among the issues to be addressed in such guidance would be how a covered person's related income is calculated when it incurs losses in intervening years that reduce its earnings and profits. Whether and when distributions in subsequent years transfer related income entirely, transfer related income proportionately, or do not transfer related income at all should also be clarified. Finally, Treasury should consider whether and under what conditions taxpayers should be permitted to trace related income based upon the best information available to them or based on reasonable and consistently-applied methodologies.

2. Loss-Sharing Splitter Arrangements: Definition of "Usable Shared Loss"

Under the Splitter Regulations, any loss-sharing outside a "U.S. combined income group" is a Splitter Arrangement if the "loss of [that] U.S. combined income group could have been used to offset income of that group" (a "**usable shared loss**") but is actually used to offset income of another U.S. combined group.[32] A U.S. combined income group of a corporation includes all entities that for U.S. tax purposes combine any of their items of income, deduction, gain or loss with those items of the corporation. Thus, a foreign corporation and any of its disregarded subsidiaries are treated as a single U.S. combined income group. By contrast, a foreign corporation and any of its subsidiaries treated as corporations for U.S. tax purposes are *not* treated as a U.S. combined income group. A Loss-Sharing Splitter Arrangement must therefore involve one or more hybrid entities.

The Splitter Regulations do not impose any express time limitation regarding when a shared loss could have been used by the loss-sharing entity. It is therefore not entirely clear whether a shared loss is deemed to be "usable" only in the taxable year it is incurred or whether it also includes foregone carrybacks and/or carryforwards.

The Splitter Regulations include an example involving a CFC ("CFC 1") and its disregarded subsidiary ("DE") in a foreign jurisdiction with a 30 percent tax rate.[33] In the example, CFC 1 has 50u of income, DE has a loss of 100u, and the U.S. combined income group of which both CFC 1 and DE are members elects to share the loss with another CFC ("CFC 2"), which is a member of a different U.S. combined income group, to offset 100u of CFC 2's income. The example concludes that the usable shared loss of CFC 1's U.S. combined income group is 50u, resulting in Split Taxes of 15u (i.e., 50u x 30 percent).

One interpretation of this example is that loss-sharing results in a Splitter Arrangement only to the extent a shared loss of a U.S. combined income group could have been used to shelter income of the group in the year of the transfer, in this case 50u. If this is correct, and if losses can generally be carried forward in the jurisdiction of the example, then the 15u of

32 Temp. Treas. Regs. § 1.909-2T(b)(2). The Splitter Arrangement requires that the loss be shared with or surrendered to a covered person. The modified 10-percent-or-more test will generally be met by entities eligible for mutual loss surrender under a foreign loss surrender or similar regime.

33 Temp. Treas. Regs. §1.909-2T(b)(2)(vii) Example (1).

foreign tax that DE or the surrendering CFC 1 will pay on the first 50u of income in the following year would not be treated as a Split Tax even though 50u of previously surrendered losses would have been available to offset the U.S. combined group's income in this year if no loss had been surrendered in the preceding year. Under this interpretation, Split Taxes would also not arise if 50u of the surrendered loss of 100u could have been carried back to a prior taxable year of CFC 1 or DE.

The argument in favor of this interpretation, in particular in the case of a carryforward, is ease of administration. Because neither the Splitter Regulations nor the example provide a clear definition of "usable shared loss," we recommend that Treasury and the IRS clarify the meaning of this term.

A definition of "usable shared loss" that included foregone carrybacks would have to take into account not only the current year taxable income of the U.S. combined income group, but also the benefit of any potential carryback of the shared loss that the U.S. combined income group chose to forego in favor of a loss surrender to another U.S. combined income group. In the case of a foregone carryback, some foreign taxes paid or accrued during earlier periods may become Split Taxes on a retroactive basis, requiring rules for redetermining which portion of such taxes become suspended Split Taxes. In addition, if the payor of such taxes is a Section 902 Corporation that has already distributed some or all of its earnings and profits, its shareholders otherwise entitled to the deemed-paid foreign tax credit under Section 902 would then have to redetermine their foreign tax credit and their U.S. tax liability.

It should be noted that in the case of loss carrybacks, Section 902 Corporations (and their disregarded subsidiaries) doing business in jurisdictions that allow loss carrybacks but do not allow loss surrenders already confront this problem under current law. On the other hand, a foreign taxing regime that permits the sharing of losses with affiliates for the current taxable year before any carryback (or forward) of any losses that remain is similar to the consolidated loss rules under U.S. tax law. Foregoing available carrybacks within the same U.S. combined income group in favor of sharing the loss will, however, result in a misalignment of the amount of foreign taxes of the U.S. combined income group (which remains unaffected) and its earnings and profits as determined for U.S. tax purposes (which will have been reduced by the amount of the surrendered loss).

A definition of "usable shared loss" that included foregone carryforwards of shared losses would require an annual retesting in each future year to which a loss could otherwise be carried forward. A loss that is not yet a usable shared loss (i.e., the portion that could not have been used by the U.S. combined income group in a closed taxable year to offset income of that group in that year) could in that case turn into a usable shared loss in a later taxable year to which it could be carried forward. As in the case of including loss carrybacks, this approach would require redeterminations of creditable foreign tax credits, which would be further complicated if a Section 902 Corporation has already distributed earnings and profits to its shareholders at the time the redetermination is made.

3. Loss-Sharing Splitter Arrangements: Related Income Determination

Losses shared outside a U.S. combined income group give rise to Splitter Events that require that the combined group that surrendered the loss take the related income into account in order to lift the suspension of the resulting Split Taxes. While this would normally occur through dividend distributions (between the entities involved in the surrender or to the relevant Section 902 shareholder), we also believe that subsequent loss-sharing in the opposite direction should be treated in the same manner as if the U.S. combined income group that originally shared its loss were taking into account related income with respect to its original Split Tax. More generally, all foreign entities should be allowed to net their mutual shared losses with respect to a given jurisdiction in determining the amount of related income that was taken into account and the amount of remaining Split Taxes.

> **Example 1**. Assume that UK corporations UKCo1, UKCo2 and UKCo3 are all wholly owned by US Parent, are treated as corporations for U.S. tax purposes and each have disregarded UK subsidiaries that are not disregarded for UK tax purposes.[34] Assume that UKCo1 surrenders a loss of 100x to UKCo2 in Year 1, UKCo2 surrenders a loss of 80x to UKCo3 in Year 2 and UKCo3 surrenders a loss of 90x to UKCo1 in Year 3. Assume further that, in Year 1, the UKCo1 U.S. combined income group had income for UK tax purposes (after the loss surrender) of 100x and thus had no income or loss for U.S. tax purposes (and would have had no income or loss for UK tax purposes if it had surrendered the loss to the one or more disregarded subsidiaries earning the 100x of income); that, in Year 2, the UKCo2 U.S. combined income group had 100x of income for UK tax purposes; and that in Year 3, the UKCo3 U.S. combined income group had 100x of income for UK tax purposes.

In Example 1, the later surrender from UKCo3 should be treated as UKCo1 taking into account 90x of the income related to the loss surrendered in Year 1. The Split Taxes relating to the remaining 10x of loss surrender should remain suspended with respect to the UKCo1 U.S. combined income group. Similarly, UKCo3 should be treated as having Split Taxes relating to

[34] Thus, each of UKCo1, UKCo2 and UKCo3 is a U.S. combined income group with other entities and, regardless of its loss surrender, may incur UK corporation taxes.

10x of usable loss at the end of Year 3 because its surrender of 90x is offset by a prior inclusion of a loss of 80x. UKCo2, on the other hand, should be treated as having related income of 20x that was not taken into account by any other U.S. combined income group because the loss surrendered to it (100x in Year 1) exceeds the loss surrendered by it (80x in Year 2).

We also do not believe that there has to be a chain of surrenders. Even if, in Example 1 above, UKCo2 did not incur, and did not surrender to UKCo3, a loss in Year 2, UKCo3's Year 3 loss surrender to UKCo1 should be treated as UKCo1 taking into account related income. UKCo1 has partially offset a prior loss surrender of 100x that resulted in Split Taxes by a loss inclusion of 90x, which for U.S. tax purposes resulted in a reduction of creditable foreign taxes without a corresponding reduction in U.S. earnings and profits. To the extent of the 90x, UKCo1 no longer has an amount of foreign tax paid or accrued that is separated from corresponding foreign income. As a result, a distribution of UKCo1's earnings and profits would not result in a deemed-paid foreign tax credit that is disproportionate to the amount of earnings and profits (except for the Split Taxes relating to the non-reversed loss surrender of 10x).

We therefore recommend that with respect to a given foreign jurisdiction, a U.S. combined income group be treated as taking into account related income to the extent a loss is surrendered, for purposes of that foreign jurisdiction's tax laws, to a member of the U.S. combined income group.

Moreover, it should not be relevant that the loss surrendered to the member of the U.S. combined income group is taken into account by that member after it, or another member, has surrendered a (usable) loss to another U.S. combined income group in a prior year. In Example 1, UKCo3 first takes into account (related) income, *i.e.*, from UKCo2's surrender to UKCo3, and therefore, to the extent of this prior inclusion, would not incur Split Taxes in Year 3. We do not see any policy reason for not allowing an advance register of losses surrendered to a U.S. combined income group that can offset the effect under Section 909 of later sharing of usable losses by the group.

We therefore recommend that a U.S. combined income group should be treated as incurring Split Taxes in a Loss-Sharing Splitter Arrangement only to the extent that the gross amount of usable losses shared by its members outside the group under the tax laws of the foreign jurisdiction exceeds the gross amount of usable shared losses used by such members under the tax laws of the foreign jurisdiction.

4. *Withdraw Prior Group Relief Regulations*

As discussed above, the Loss-Sharing Splitter Arrangement is different from the 2007 Proposed Regulations in that it does not challenge the compulsory nature of the foreign income tax. While the two provisions are not technically inconsistent, we believe that the 2007 Proposed Regulations no longer serve any useful purpose. To the extent that Split Taxes arise from Loss-Sharing Splitter Arrangements, they are suspended and thus not available for credit (or the foreign tax credit pool) until the related income is taken into account.

We do not believe that there should be a second inquiry at that time regarding whether the foreign taxes paid by the U.S. combined income group in the year of the Splitting Event or in a later year when income is recognized for foreign tax purposes that, for U.S. tax purposes, is offset by the surrendered loss are compulsory. In the year of the Splitting Event, the taxes are Split Taxes. There is, therefore, no further need to disallow them under a regime along the lines of the 2007 Proposed Regulations. We therefore recommend that Treasury withdraw the 2007 Proposed Regulations.

5. *Timing of Covered Person Relationship*

The Splitter Regulations clarify that a Splitting Event occurs regardless of when the related income is taken into income by a covered person. The Splitter Regulations are not clear, however, when the covered person's status and relationship to the payor of the foreign tax must be determined (*i.e.*, at the time the foreign tax is paid or accrued, the time the related income is taken into account by the covered person, or both). While it is unlikely that a person will be a covered person at one time but not the other, if timing differences combine with a Splitting Event, intervening corporate transactions (such as stock acquisitions or dispositions, or mergers) could give rise to situations of this kind.

> **Example 2**. X is a U.S. shareholder that owns 9.9 percent of the stock of a reverse hybrid (RH). The only income of RH for foreign tax purposes in Year 1 is attributable to a sale of zero basis property for a $100 note due in three years. Because the foreign jurisdiction does not permit installment reporting, RH has $100 of income, resulting in $50 of foreign tax. When the note is paid in Year 3, X owns 100 percent of the stock of RH.

In this case, RH is not a covered person with respect to X when the foreign tax is paid but is a covered person when the related foreign income is taken into account.

> **Example 2A**. The facts are the same as in Example 2, except that X owns 100 percent of the stock or RH in Year 1 and then sells 90.1 percent of the stock before Year 3.

In this case, RH is a covered person with respect to X when the foreign tax is paid but not a covered person when the related foreign income is taken into account.

In order to avoid any potential manipulation of the purposes of Section 909, therefore, we believe final regulations should clarify that a Splitting Event occurs not only regardless of when the related income is taken into account by a covered person, but regardless of whether the covered person relationship exists only at the time the foreign tax is paid or accrued or at the time the related income is taken into account.[35] For the reasons cited in Section V.B.8 below, to the extent that any foreign taxes paid by X in Year 1 in Example 2A would remain suspended after the sale of 90.1 percent of RH, X should be permitted to increase its basis in the stock immediately before the sale.

6. Attribute Carryover for Successors and Consolidated Groups

The Splitter Regulations provide several rules for the transfer of Split Taxes and related income. For example, a Section 902 shareholder is treated as taking into account related income if the income is taken into account as gross income by a member of the same U.S. consolidated group (the "**Consolidation Rule**").[36] Further, related income is transferred to another corporation in the same manner as earnings and profits under Section 381 or Treasury Regulations § 1.367(b)-7 (the "**Successor Rule**").[37] A Successor Rule also applies to Split Taxes, and the Splitter Regulations state that "the transferee foreign corporation will be treated as the payor [S]ection 902 [C]orporation with respect to" the Split Taxes.[38] Finally, a payor Section 902 Corporation is treated as taking into account related income when it and the covered person are combined in a transaction described in Section 381(a)(1) or (a)(2).[39]

We have three recommendations regarding the scope of these rules.

First, if a Section 902 shareholder were to liquidate or otherwise acquire a first-tier CFC in a Section 381 transaction, it should be permitted to succeed to any Split Taxes of the first-tier CFC attributable to its ownership of a reverse hybrid. If the reverse hybrid later distributes the

---

35 By making the Splitting Event retroactive, however, U.S. taxpayers who claimed the credit in a taxable year before any covered person relationship existed would presumably be required to file an amended return.

36 *See* Temp. Treas. Regs. § 1.909-6T(d)(9).

37 *See* Temp. Treas. Regs. § 1.909-6T(d)(6).

38 *See* Temp. Treas. Regs. § 1.909-6T(e)(3).

39 *See* Temp. Treas. Regs. § 1.909-6T(d)(8)(ii).

related income to the Section 902 shareholder after the transaction, the Section 902 shareholder would then be permitted to claim a foreign tax credit for the Split Taxes.

By its terms, however, Temporary Treasury Regulations § 1.909-6T(e)(3) does not apply to such a transaction. It provides that --

> Pre-2011 split taxes that carry over to another *foreign* corporation, including under section 381, §1.367(b)-7 or similar rules, retain their character as pre-2011 split taxes. The transferee *foreign* corporation will be treated as the payor section 902 corporation with respect to those pre-2011 split taxes.[40]

Because a Section 902 shareholder is not a "foreign corporation",[41] this regulation would not permit it to succeed to the Split Taxes of the transferor foreign corporation. We believe this was a drafting error. We therefore recommend that Treasury expand the scope of Temporary Treasury Regulations § 1.909-6T(e)(3) to treat a Section 902 shareholder as the payor of any Split Taxes of the transferor Section 902 Corporation to the same extent as a transferee foreign corporation would be so treated.

Second, Temporary Treasury Regulations § 1.909-3T(a) extends the successor rules described above as an "interim rule" by providing that their "principles" apply to related income and Split Taxes for post-2010 taxable years. Although we support this approach, we believe the rules should be clarified in final regulations. It is not entirely clear, for example, whether a rule akin to the Consolidation Rule applies when the Split Taxes are transferred (under the Successor Rule) to a member of the same consolidated group of which the covered person is also a member. We are not aware of any policy reason for failing to treat this case as symmetrical to the Consolidation Rule.

Third, we recommend that final regulations clarify the extent to which the "principles" of the Splitter Regulations, as they apply to pre-2011 Split Taxes of Section 902 Corporations pursuant to Temporary Treasury Regulations §1.909-6T(d) through (f), also apply to Section 902 shareholders (as will be illustrated in more detail in the next section).

7. Section 909 and Deductibility of Foreign Income Taxes: Inbound Liquidations and Asset Transfers

When a Section 902 Corporation is liquidated into a domestic corporation under Section 332 and the domestic corporation is a Section 902 shareholder or when the assets of a Section 902 Corporation are transferred to a domestic corporation in an asset acquisition described in

40 *See* Temp. Treas. Regs. § 1.909-6T(e)(3) (emphasis added).

41 See Temp. Treas. Regs. § 1.909-1T(a)(1).

Section 368(a)(1), a United States shareholder (as defined in Section 951(b)) must include the "all earnings and profits amount" as a deemed dividend.[42] The all earnings and profits amount is the net positive earnings and profits (if any) determined under Section 312, with certain adjustments, attributable to the stock under the attribution rules of Section 1248.

The Splitter Regulations do not make any adjustments for Split Taxes to the all earnings and profits amount (nor would such amount include the related income). Thus, if a domestic corporation were to liquidate a first-tier CFC that owned a reverse hybrid, it would include the CFC's earnings and profits unreduced by its suspended Split Taxes. Because it should also succeed to the first-tier CFC's Split Taxes and thus the opportunity to credit such Split Taxes when the reverse hybrid ultimately distributes the related income,[43] we believe this is appropriate.

But suppose that the first-tier CFC itself is a reverse hybrid. Assuming sufficient attributable earnings and profits, the Section 902 shareholder of the CFC would include all of the related income in the liquidation, in which case Section 909 would no longer apply.[44] But if the related income of the CFC exceeded the attributable earnings and profits (*e.g.*, due to intervening losses), [45]the Section 902 shareholder would take into account only a portion of the related income.

> **Example 3:** A domestic corporation (USCo) owns 100 percent of the stock of a foreign reverse hybrid, (RH). At the start of Year 1, RH has no earnings and profits and no related income under Section 909 from prior years. In Year 1, RH earns $100 of net income and USCo pays $35 for foreign taxes. RH does not distribute any of its earnings and profits in Year 1. In Year 2, RH incurs a net loss of $50, which it is not permitted to carryback under foreign law. If RH paid a $50 dividend in Year 2, USCo would take $50 of related income into account, releasing $17.50 of Split Taxes. If RH earns another $50 in Year 3 but pays no foreign tax because it is permitted to carryforward the Year 2 loss, USCo could liquidate RH in Year 3 and claim the benefit of the remaining $17.50 of Split Taxes.

---

42 Treas. Regs. §§ 1.367(b)-3(a) and (b).

43 *See* Temp. Treas. Regs. § 1.909-6T(e)(3), as applying to post-2010 Split Taxes pursuant to Temp. Treas. Regs. § 1.909-3T(a). As discussed more fully in the immediately preceding section of this report, this assumes that final regulations expand the scope of this regulation to include transferee domestic corporations as successor payors. The domestic corporation would also succeed to any related income of the first-tier CFC. Temp. Treas. Regs. § 1.909-6T(d)(6), as applying to post-2010 Split Taxes pursuant to Temp. Treas. Regs. § 1.909-3T(a).

44 Treas. Regs. § 1.909-6T(d)(7).

45 Id.

> If USCo had instead liquidated RH at the end of Year 2, it would release the same $17.50 of Split Taxes as a result of the all earnings and profits inclusion. The remaining Split Tax of $17.50, however, would not be released, either in the year of liquidation or in any later year.

If a foreign Section 902 Corporation had owned RH in this example, it would be treated as having taken into account the entire related income of RH in the Section 332 liquidation regardless of its earnings and profits. The reason is that the payor and the covered person will have combined in a transaction described in Section 381(a)(1).[46] Does applying the "principle" of this rule mean that a combination of USCo in the above example (a domestic payor that is not a Section 902 Corporation) and RH (the covered person) in a transaction described in Section 381(a)(1) results in the related income being taken into account? If so, the Split Taxes attributable to RH would no longer be suspended regardless of RH's earnings and profits. As a result, USCo would be permitted to claim a foreign tax credit without reporting the related income.

Although we do not believe the principles of these rules were intended to apply to a Section 902 shareholder, the continued suspension of a portion of the Split Tax in such a case would also result in permanent disallowance. We therefore recommend that final regulations permit a Section 902 shareholder to elect to either claim the foreign tax credit to the extent of any related income taken into account in the liquidation or to reduce the earnings and profits of the RH up to the amount of the Split Taxes, in effect treating the Split Taxes as contributed to the capital of the RH and then paid by the RH in reduction of its earnings and profits.

8. Section 909 and Deductibility of Foreign Income Taxes: Dispositions of the Covered Person or the Payor

Under the Splitter Regulations, Split Taxes from a Splitting Event remain suspended for an indefinite time until the related income is reunited with the payor or the Section 902 shareholder (or a member of its consolidated group). One consequence of this rule is that a suspension may never be lifted if the person that originally was a covered person with respect to the Splitting Arrangement ceases to be a covered person with respect to the payor of the Split Taxes. Once the payor of the Split Tax and the covered person no longer stand in the relevant relationship, the suspension of the foreign tax credit is likely to result in permanent disallowance.

46 Temp. Treas. Regs. § 1.909-6T(d)(8)(ii).

A typical transaction that breaks the covered person relationship is a taxable sale of the stock of the covered person, either directly or indirectly, to an unrelated person. Assume, for example, that the covered person is a controlled foreign corporation and the seller is a domestic corporation ("Seller"). If the gain recognized in the sale that is recharacterized as a dividend under Section 1248 fully reunites the related income,[47] none of the Split Taxes will remain suspended. It is quite possible, however, that the sale will not reunite all of the related income under Section 1248. For example, the total gain recognized on the sale may be less than the related income or, even if not, characterized as a dividend consisting in part of related income and in part of other income under the pro-rata rule.[48] In such a case, any future credit for the portion of the Split Taxes that remains suspended after the sale is likely to be permanently disallowed.

Although we do not believe that releasing the suspension for any residual Split Taxes on such a sale would be consistent with the purposes of Section 909, we believe that the fact that the payor has borne the economic burden of the Split Taxes should be reflected. Otherwise, the payor (or its affiliates) would never be able to obtain any benefit from incurring the foreign tax expense once it no longer owns the covered person with the related income.

We believe that the appropriate approach in this case is to treat the payor as having paid the foreign tax on behalf of the covered person. Thus, if the covered person so disposed of is a direct or indirect subsidiary of the retained payor corporation, the payor should be treated as having made a contribution to the capital of the covered person, the payor's tax basis in the stock of the covered person should be treated as increased by the amount of the foreign tax treated as so contributed, and the covered person should be treated as having paid the foreign tax and reduced its earnings and profits accordingly.[49] If the payor owns the stock of the covered person indirectly, it should be treated as having made the capital contributions through the chain of intermediate entities, with the corresponding increase in the tax basis of the intermediate entities.[50] As a result, the Seller would obtain an increased tax basis in the stock of

---

47 The Seller would have to stand in one of four relationships with the payor of the foreign tax in this case: (1) the Seller is the payor of the foreign tax; (2) the Seller is a member of the same consolidated group as the payor of the foreign tax; (3) the Seller is a Section 902 shareholder of the payor Section 902 Corporation that paid the foreign tax; or (4) the Seller is a member of the same consolidated group as (one or more) Section 902 shareholders of the payor Section 902 Corporation that paid the foreign tax.

48 Temp. Treas. Reg. § 1.909-6T(d)(3).

49 Under this approach, the amount of gain subject to Section 1248 would also be reduced.

50 Similarly, if the payor is a sister corporation of the disposed of covered person, the payor should be treated as having distributed the amount of foreign tax to the common parent (up the chain of intervening shareholders, if applicable), followed by a contribution to the capital of the covered person (down the

the sold entity immediately before the sale, which allows the Seller to recover the expense in the form of reduced gain (or increased loss) on the sale.

9. *Expand Covered Person Definition for U.S. Debt Hybrid Instrument Splitter Arrangements*

In our Partnership Section 909 Report, we recommended that the safe harbor rule under prior Treasury Regulations § 1.704-1(b)(4)(viii)(*d*)(*3*) for disregarded inter-branch payments be eliminated. Although we believe that the kind of abuse that Section 909 was intended to address would generally occur only in the case of related partners, we recommended the complete elimination of the safe harbor rule. It is unlikely that unrelated partners would agree to the uneconomic allocations described in the example. Leaving the safe harbor intact for unrelated partners would therefore not serve any useful purpose. We commend Treasury for eliminating this rule and clarifying how such an inter-branch payment could result in a Splitting Event.

In the same report, we also recommended that no change be made in the case of deductible guaranteed payments within the meaning of Section 707(c). While income attributable to an activity generally includes the amount included in a partner's income as a guaranteed payment, it does so only to the extent the guaranteed payment is not deductible.[51] Income attributable to an activity of a partnership also does not include any item of partnership income to the extent the allocation of such item of income (or payment thereof) results in a deduction under foreign law.[52] Thus, the following example should not be treated as an allocation in accordance with the partners' interest in the partnership:

> **Example 4**. AB is a Country X corporation and has two classes of interests outstanding, the EE interest and DE interest. The EE interest is equity for Country X and U.S. tax purposes; the DE interest is treated as debt for Country X tax purposes and equity for U.S. tax purposes. For U.S. tax purposes, AB is a partnership. A owns the EE interest and B owns the DE interest; A and B are unrelated and would not be covered persons in relation to each other under Section 909.
>
> AB operates business M in Country X, which imposes a 20 percent tax on the income from business M. The tax is a CFTE (as defined below). In Year 1, AB earns $200,000 of net income before taking into account the payment on the DE interest, and makes a payment of $100,000 on the DE

chain of intervening owners, if applicable), and the general rules applicable to distributions should apply in addition to the treatment of the contribution described above.

51 Treas. Regs. § 1.704-1(b)(4)(viii)(*c*)(*3*)(ii).

52 *Id*.

> interest to A. AB's net income as determined for Country X tax purposes is $100,000, resulting in $20,000 of tax to AB.
>
> Under the partnership agreement, the Country X tax is allocated to A and B for U.S. tax purposes in the same proportion as their payments on the EE interest and DE interest.

Example 4 does not represent a U.S. equity Hybrid Instrument Splitter Arrangement because the instrument in fact gives rise to income for U.S. tax purposes (through a partnership allocation). However, the allocation is not in accordance with the partners' interests in the partnership because the $100,000 of income attributable to business M of AB and allocated to B consists of items of partnership income whose payment results in a deduction under the laws of Country X, similar to deductible guaranteed payments and deductible preferential gross income allocations.

For the reasons described in our Partnership Section 909 Report, we believe that this result is correct and commend Treasury and the IRS for leaving this provision undisturbed, rather than characterizing the allocation as a Splitting Event that results in a suspension of creditable foreign tax expenditures ("**CFTEs**").

The converse case, however, is not subject to either the partnership rules or the Splitter Regulations:

> **Example 5**. AB is a Country X corporation and has two classes of interests outstanding, the EE interest and the ED interest. The EE interest is equity for Country X and U.S. tax purposes, representing a 50 percent ownership interest in AB for Country X tax purposes; the ED interest is treated as equity for Country X tax purposes and debt for U.S. tax purposes, also representing a 50 percent ownership interest in AB for Country X purposes. For U.S. tax purposes, AB is a disregarded entity. A owns the EE interest and B owns the ED interest; A and B are otherwise unrelated.
>
> AB operates active business M in Country X, which imposes a 20 percent income tax on the income from business M. In Year 1, AB earns $200,000 of net income for Country X tax purposes and $120,000 of net income for U.S. tax purposes. AB pays $40,000 of Country X taxes, pays $80,000 to B in respect of the ED interest and $80,000 to A in respect of the EE interest.

Because AB is a disregarded entity rather than a partnership for U.S. tax purposes, the partnership rules do not apply. Because AB operates an active business, this arrangement is not a structured passive investment arrangement within the meaning of Treasury Regulations § 1.901-2(e)(5)(iv). Under the Splitter Regulations, this is a Splitter Arrangement, more specifically a U.S. debt Hybrid Instrument Splitter Arrangement. It does not give rise to a Splitting Event, however, and there are no Split Taxes, because B, whose income from holding the ED interest is related to $20,000 of foreign taxes otherwise creditable by A, is not a covered person with respect to A, the payor of the Country X income tax for U.S. tax purposes.

The rationale for not covering Example 5 as a Splitting Event is not clear. Although there would be no Splitting Event in the converse case, the partnership rules specifically back-stop the arrangement because the allocations of CFTEs is not in accordance with the partners' interest in the partnership. If AB were not engaged in an active trade or business and if substantially all of its income were passive investment income (or substantially all of its asset produced passive investment income), a foreign tax credit would be disallowed because it would be treated as attributable to a structured passive investment arrangement.[53]

We believe Example 5 should be treated as a Splitter Event subject to Section 909. Closely related, similar transactions are captured (albeit by other provisions of the Code), resulting in a reallocation or disallowance of foreign tax credits. We are not aware of any aspect of the transaction described in Example 5 that would warrant substantially different treatment. We therefore believe it should be subject to Section 909.

One approach to bringing this transaction within the statute would be to extend the definition of "covered person" in the context of U.S. debt Hybrid Instrument Splitter Arrangements. This could be achieved as follows: First, the hybrid instrument itself could be treated as an ownership interest for purposes of determining the covered person relationship. Second, under the 10 percent or greater ownership test, B would then be treated as a covered person if it owned a 10 percent or greater interest, including the ED instrument, in A, or both A and B owned a 10 percent or more interest in AB (the disregarded entity). In Example 5, because both A and B have a greater than 10 percent interest in AB, they would be treated as covered persons for purposes of determining the presence of a U.S. debt Hybrid Instrument Splitter Arrangement, and $20,000 of the Country X income taxes of AG would be Split Taxes. We believe this is the appropriate result.

[53] Treas. Regs. § 1.901-2(e)(5)(iv).