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What's New in the Technical Taxpayer and §909 Guidance

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On Valentine's Day 2012, the IRS and Treasury gave the tax practitioner community the gift of final and temporary regulations targeting the separation of foreign tax credits from the income subject to the foreign taxes giving rise to the credits — generally known as foreign tax credit "splitters."[1] Given how complex these rules might have been, it is hard to view this initial round of guidance as anything other than flowers and bonbons, although not all taxpayers may view it that way. The first part of this article peels back the wrapping paper by providing some context for the guidance. The second part highlights what is new and shiny in the §901 guidance, principally by comparison to the 2006 Proposed Regulations.[2] The third part covers what is new in the §909 guidance, relative to Notice 2010-92.[3] The fourth part suggests what might be coming next.

[1] *See* T.D. 9576, 77 Fed. Reg. 8120 (2/14/12); T.D. 9577, 77 Fed. Reg. 8127 (2/14/12).

[2] NPRM, "Definition of Taxpayer for Purposes of Section 901 and Related Matters," 71 Fed. Reg. 44240 (8/4/06). All section ("§") references are to the U.S. Internal Revenue Code of 1986, as amended ("the Code") and the regulations thereunder unless otherwise indicated.

[3] 2010-52 I.R.B. 916.

BACKGROUND FOR THE GUIDANCE

A U.S. taxpayer generally is entitled to a credit for the amount of any income tax paid or accrued during the taxable year to a foreign country or a possession of the United States.[4] The taxpayer eligible to claim the credit is the person who is legally liable for the tax under foreign law, regardless of who remits the tax (the "technical taxpayer rule").[5] The technical taxpayer rule tolerates the separation of the foreign tax credit from the income upon which the foreign tax was imposed. This separation or splitting effect became the subject of *Guardian Industries Corp. & Subs. v. U.S.*[6] In that case, the U.S. taxpayer claimed a credit for income taxes imposed on its Luxembourg disregarded entity, which alone was liable for the tax imposed on its Luxembourg affiliates. Those affiliates were controlled foreign corporations (CFCs), the earnings of which were not subject to current U.S. taxation. Thus, the taxpayer claimed the credit now but could defer, potentially indefinitely, recognition of the income upon which the foreign tax was imposed. The IRS challenged this structure in court but lost.[7]

In response, the IRS and Treasury proposed regulations in 2006 to modify the technical taxpayer rule. The 2006 Proposed Regulations generally would have changed the rule to treat the taxpayer for credit purposes as the person who earned the income under foreign law.[8] On the facts of *Guardian Industries*, the regulations would have pushed the Luxembourg tax

[4] §901.

[5] Regs. §1.901-2(f)(1).

[6] 65 Fed. Cl. 50 (2005), *aff'd*, 477 F.3d 1368 (Fed. Cir. 2007).

[7] *See id.*

[8] Prop. Regs. §1.901-2(f)(1)(i), 71 Fed. Reg. 44240, 44243–44 (8/4/06).

down into the affiliates who earned the income.[9] The U.S. taxpayer would not have been able to claim the credit until those subsidiaries repatriated their earnings. The 2006 Proposed Regulations would have reduced the instances of foreign taxes becoming separated from related income, but the regulations languished for several years without being finalized. The main obstacle to finalization apparently was a technical problem with their treatment of reverse hybrids (i.e., an entity treated as a corporation for U.S. purposes but as a partnership for foreign purposes). The 2006 Proposed Regulations attempted to push the owner-level taxes back down into the reverse hybrid, but, in so doing, the regulations could have allowed a domestic corporation to claim indirect credits for taxes paid by foreign owners of the reverse hybrid.[10] At the urging of the Obama administration, Congress intervened by enacting §909 in 2010.

Under §909, if there is a ''foreign tax credit splitting event'' (''FTCSE'')[11] with respect to a foreign income tax paid or accrued by a taxpayer, including a §902 corporation, the tax (commonly referred to as the ''split tax'') is suspended for U.S. federal income tax purposes until the related income is taken into account.[12] Under the statute, a FTCSE occurs with respect to a foreign income tax if the related income ''is (or will be)'' taken into account for U.S. federal income tax purposes by a person who: (1) is at least a 10% owner of, or 10%-owned by, the taxpayer; or (2) satisfies certain other indicia of relatedness described in the Code and regulations.[13] The statute somewhat unhelpfully defines ''related income'' as the income to which a foreign income tax relates.[14]

Section 909 applies to foreign income taxes paid or accrued in taxable years beginning after 2010, but the statute also contemplates retroactive application with respect to deemed-paid credits.[15] Section 909 does not apply to taxes deemed paid before 2011, but it can apply to taxes deemed paid in 2011 or a later year even if the FTCSE occurred before 2011.[16] In Notice 2010-92,[17] the IRS and Treasury helpfully limited the retroactive application of §909.

The Notice identified an exclusive list of four structures that are treated as giving rise to FTCSEs in pre-2011 years (''pre-2011 splitter arrangements''). Such arrangements include certain: (1) reverse hybrid structures; (2) foreign consolidated groups; (3) disregarded debt instruments combined with group relief; and (4) hybrid instruments.[18] The Notice included rules regarding the calculation of related income and split taxes for purposes of pre-2011 splitter arrangements, as well as rules relating to the application of §909 to partnerships and trusts in pre-2011 years.[19]

In addition to guidance on the retroactive application of §909, Notice 2010-92 also clarified the interaction between §909 and §§904(c), 905(a), and 905(c).[20] It requested comments on various issues, and it noted that the four pre-2011 splitter arrangements, plus a fifth arrangement, would continue to be subject to §909 after 2010. The fifth arrangement, described below in greater detail as the ''Tractor,'' involves the treatment under §704(b) of disregarded payments among disregarded entities (DEs) owned by a partnership. As promised in Notice 2010-92, the IRS and Treasury on February 14, 2012, issued final, temporary, and proposed regulations (the ''2012 Regulations'') containing the rules of Notice 2010-92, related guidance under §901, and additional forward-looking guidance.

SECTION 901 GUIDANCE

The Technical Taxpayer Rule Generally

While the 2012 Regulations were being drafted, commentators asked the IRS and Treasury to finalize the 2006 Proposed Regulations — rather than subject taxpayers to §909 — in a couple of fact patterns.[21] The fact patterns were foreign consolidated groups similar to the *Guardian Industries* case and mid-year transfers of DEs and hybrid partnerships. In these situations, the 2006 Proposed Regulations were viewed as providing results satisfactory to the government but computationally easier, at least when compared to §909. In the 2012 Regulations, the IRS and Treasury accommodated these requests and modified the technical taxpayer rule to cover them. By pushing the credit into the foreign income-earner in these fact patterns, the 2012 Regulations took them outside the scope of §909.

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[9] *See id.*; *Guardian Industries*, 477 F.3d at 1373–75.

[10] *See* Joint Comm. on Tax'n, 111th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment, at 103–04 (2009).

[11] In the spirit of Valentine's Day, shouldn't we all just agree now that we are going to pronounce this ''footsie''?

[12] §909(a).

[13] §909(d)(1), (4)(A)–(D).

[14] §909(d)(3).

[15] *See* P.L. 111-226, §211(c)(2), 124 Stat. 2389, 2396 (2010); *see also* Joint Comm. on Tax'n, 111th Cong., Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, at 6–7 (2010).

[16] Section 909 applies retroactively only for purposes of the §§902 and 960 credits; it does not apply retroactively for purposes of computing the post-1986 earnings pool. *See* P.L. 111-226, §211(c), 124 Stat. 2389, 2395–96 (2010). Thus, according to Notice 2010-92, there is no increase to a §902 corporation's earnings and profits for the amount of any pre-2011 split foreign taxes that were previously deducted in computing earnings and profits in a pre-2011 taxable year. Notice 2010-92, §2.02, 2010-52 I.R.B. 916, 918.

[17] 2010-52 I.R.B. 916, 918.

[18] *Id.* at 919–20.

[19] *Id.* at 920–21.

[20] *Id.* at 922.

[21] *See* 77 Fed. Reg. at 8121, 8123.

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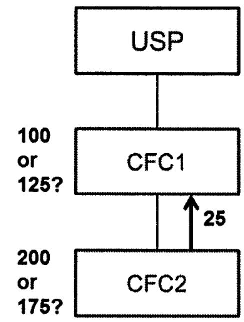
Other than in these situations, the 2012 Regulations did not modify the technical taxpayer rule.[22] They generally leave to §909 and other provisions, such as §901(k) through (m), the task of addressing splitting events. However, the regulations do note that the IRS is considering other revisions to the rule, in particular the treatment of certain withholding taxes and repo transactions.[23] On repo transactions, the IRS has commented publicly that there are various ways of ensuring that the credit is matched to the income, but no decision appears to have been made whether to use §901, §909, or some other rule to do so.[24]

Foreign Consolidated Groups

The 2012 Regulations provide that, if a foreign tax is imposed on the combined income of two or more taxpayers, foreign law is deemed to impose legal liability in accordance with each taxpayer's share of the combined income.[25] The foreign tax is allocated among the group members based on their pro rata share of combined income, determined under foreign law. To match the foreign tax with related income, both the combined income and a member's share are computed separately for each foreign tax that is imposed on a combined basis, as well as for any combined income that is subject to tax exemption or a preferential tax rate. These rules apply regardless of whether a particular member is obligated to remit or actually remits a tax, and regardless of whether the foreign country could proceed against a particular member in order to collect the tax.[26]

The 2012 Regulations generally follow the foreign-law treatment of payments among foreign group members in determining the separate taxable income of each for purposes of allocating the foreign tax.[27] Under the 2006 Proposed Regulations, it was unclear whether payments that are deductible under foreign law but not deductible or disregarded under U.S. law would be given effect for this purpose.[28] In general, they now are. However, the 2012 Regulations do override foreign law in certain respects. A member's share of combined income generally is calculated by giving effect to a deductible payment between group members (e.g., interest) if the payment would have been deductible and includible under foreign law if the group members had been separate corporations.[29] These payments thus are respected even if they would have been eliminated in consolidation under foreign law. Conversely, a member's share of combined income is calculated without taking into account dividends received from other group members, and without taking into account deemed dividends or other income attributed from one member to another under foreign consolidation rules.[30] The 2012 Regulations override foreign law in these cases to clarify that foreign consolidation rules attributing income to the upper tier of a group will not push foreign taxes to the upper tier.



Example.[31] USP owns CFC1, which owns CFC2. CFC1 and CFC2 are incorporated in the same country and compute their income on a combined basis. Under foreign law, CFC1 and CFC2 have $100 and $200 of income, respectively. At the end of the year, CFC2 pays $25 of interest to CFC1, and the interest payment is eliminated under foreign consolidation rules. A foreign tax is then imposed on CFC1 and CFC2's combined income ($300). Under the 2012 Regulations, the foreign tax is allocated between CFC1 and CFC2 based on their pro rata share of combined income, determined under foreign law. The interest payment from CFC2 to CFC1 would be taken into account in calculating each CFC's share of the group's combined income, even if foreign law would eliminate the payment in consolidation. Therefore, $125/$300 (approximately 42%) of the foreign tax would be allocated to CFC1, and $175/$300 (approximately 58%) would be allocated to CFC2. If the payment from CFC2 to CFC1 were a dividend, by contrast, it would be disregarded in allocating the tax. The tax would be allocated one-third to CFC1 and two-thirds to CFC2.

The 2012 Regulations warn that payments among members of a combined income group could give rise to §909 FTCSEs. For example, the $25 payment could give rise to a FTCSE in the example above if the instrument between CFC1 and CFC2 were a hybrid instrument.[32] The payment might be treated as interest under foreign law, deductible to CFC2 and includible to CFC1, but as a nontaxable stock dividend under U.S. law. In that case, the §901 regulations would give it effect for purposes of allocating the tax, but §909 would apply as well. If the payment does give rise to a §909 FTCSE, the foreign tax attributable to the payment would be suspended until the related income is taken into account. At least in theory, a FTCSE even could arise in a situation where foreign law disregards the payment on the ground that it oc-

[22] *See id.* at 8121; Regs. §1.901-2(f)(1).

[23] *See* 77 Fed. Reg. 8121.

[24] *See id.*

[25] Regs. §1.901-2(f)(3)(i).

[26] *Id.*

[27] Regs. §1.901-2(f)(3)(iii)(B)(*2*).

[28] *See* 77 Fed. Reg. 8122.

[29] Regs. §1.901-2(f)(3)(iii)(B)(*1*).

[30] *Id.*

[31] *See* Regs. §1.901-2(f)(5), *Ex. 1*.

[32] *See* Regs. §1.901-2(f)(3)(iii)(B)(*2*).

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curs between members of a consolidated group. U.S. law might override foreign law in this respect and require the payment to be given effect as a deductible payment, if that would be the foreign-law treatment outside of consolidation. If the payment does not give rise to income under U.S. law, an FTCSE could be created, even though there would be no difference in treatment under U.S. and foreign law if the regulations simply followed the foreign consolidation rules.

Hybrid Entities

The 2012 Regulations generally follow the 2006 Proposed Regulations and allocate taxes imposed on DEs and hybrid partnerships that experience an ownership change during the year if the ownership change is disregarded for foreign tax purposes.[33]

In general, the owner of a DE is treated as the technical taxpayer of the foreign tax imposed on the DE, and the hybrid partnership is treated as the technical taxpayer of the foreign tax imposed on the partnership.[34] The foreign income tax on such entities often accrues for U.S. tax purposes at the end of the year.[35] An ownership change during the year thus can result in the separation of income earned before the change from the tax that accrues after the change. The 2012 Regulations prevent this outcome by allocating the tax between the two (or more) ownership periods based on when the income accrues.

Example. USP owns DE, which ''un-checks'' and thus becomes a CFC mid-way through its taxable year. The foreign corporate income tax accrues at the end of the CFC's taxable year. As a result, USP accrues the entity's income for the half of the year while it was a DE, but all of the foreign income taxes for the year are imposed on the CFC, which accrues the other half of the income for U.S. tax purposes. Under the 2012 Regulations, the foreign tax imposed on the DE is allocated between USP and CFC based on ''the principles of §1.1502-76(b).''[36] So long as there are no extraordinary items recognized before or after the ownership change, the consolidated return regulations permit income to be allocated ratably over the year. In this example, half of the tax would go to USP, and half to CFC.

In the opposite case, where a CFC checks the box to become a DE during the year, the allocation of the tax may be simpler. Whatever taxes are allocated to the portion of the year before the election would become deemed-paid credits accompanying the §367(b) ''all earnings and profits'' inclusion arising from the check-the-box liquidation of CFC into USP.[37] All of the income and taxes for the year thus could wind up at USP anyway. If the CFC has a cumulative deficit in earnings and profits (E&P), then the allocation of foreign taxes back into the pre-election period in theory could result in the taxes being eliminated.[38] If the CFC electing DE treatment is a subsidiary of a CFC with a hovering deficit, the portion of the taxes allocated to the pre-election portion of the year could become subject to the hovering deficit as of the end of the year.[39]

One should also note that §901(m), which denies the foreign tax credit for certain foreign income taxes paid in the context of a ''covered asset acquisition,''[40] can apply even where the 2012 Regulations eliminate the separation of income and credit. For example, assume that USP owns CFC1 and CFC2 and that CFC1 sells DE to CFC2 during the year. In this situation, the 2012 Regulations generally would allocate the tax imposed on DE at the end of its year based on the relative amounts of income included by CFC1 and CFC2 under foreign law. This allocation generally would ensure that there is no separation of income from credit. However, the transaction still would meet the statutory definition of a §901(m) covered asset acquisition because it is an asset acquisition for U.S. purposes and a stock acquisition for foreign purposes.[41] Section 901(m) therefore generally would deny a portion of the foreign tax credit for the year, computed using the difference in U.S. tax basis in the assets before and after the sale. The IRS and Treasury did not specifically address this issue in the 2012 Regulations. They have commented publicly, however, that §901(m) could apply either before or after the allocation of the foreign tax between CFC1 and CFC2. Perhaps this issue will be addressed in the §901(m) guidance, expected later this year.

Another point to mention in this fact pattern is that USP might want to cause CFC1 to set up a payable and CFC2 to set up a receivable for U.S. tax purposes to reflect the fact that the payment of tax for the full year occurs when CFC2 owns the DE. According to the 2012 Regulations, U.S. tax principles apply to determine the tax consequences if CFC2 remits a tax for which CFC1 is liable.[42] In the absence of a receivable and a payable, the IRS has stated publicly that there may be a deemed dividend from CFC2 to USP equal to the amount of tax paid by DE on behalf of CFC1,

[33] *See* 77 Fed. Reg. at 8123.

[34] *See id.*; Regs.§1.901-2(f)(4)(i)–(ii). The IRS received comments suggesting that, if an ownership change or termination of a partnership would result in an allocation of partnership items based on the closing-of-the-books method outlined in §§706 and 708 and the regulations thereunder, the partnership's foreign tax should be allocated based on the same closing-of-the-books method in the change year. The IRS rejected this proposal because of concerns about administrative burden. *See* 77 Fed. Reg. 8123.

[35] *See* Rev. Rul. 61-93, 1961-1 C.B. 390.

[36] Regs. §1.901-2(f)(4)(ii).

[37] *See generally* Regs. §1.367(b)-2(e)(2).

[38] *See generally* Regs. §1.367(b)-3(d)(1) and (2).

[39] *See* Regs. §1.367(b)-7(c), (d).

[40] A covered asset acquisition generally is defined as: (1) a qualified stock purchase to which §338(a) applies; (2) a transaction that is treated as an asset acquisition for U.S. tax purposes and as disregarded or as a stock acquisition for foreign tax purposes; (3) an acquisition of an interest in a partnership that has made a §754 election; and (4) any similar transaction identified in future guidance. §901(m)(2).

[41] *See* §901(m)(2)(B).

[42] *See* Regs. §1.901-2(f)(3)(iv).

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followed by a deemed capital contribution from USP to CFC1 to account for its continuing ownership of assets it otherwise would have used to pay the tax.[43]

Effective Dates

The §901 piece of the 2012 Regulations generally is effective for taxes paid or accrued in taxable years beginning after February 14, 2012.[44] However, taxpayers can apply the combined income rules to taxable years beginning after 2010.[45] Otherwise, the technical taxpayer rules in effect in the year in which foreign taxes are paid or accrued govern their treatment when they are carried forward or back under §904(c) and applied in a subsequent or prior year.[46] For example, an excess foreign tax credit arising from a *Guardian Industries*–type fact pattern in 2008 would still be treated as paid or accrued by the U.S. owner of the foreign group parent when carried to 2013, even though the excess credit otherwise is treated for purposes of §904(c) as ''paid or accrued'' in the later year.

SECTION 909 GUIDANCE

General Approach

The 2012 Regulations generally follow the taxpayer-favorable approach of Notice 2010-92 in providing a defined list of FTCSEs — a so-called ''devil list'' approach. The IRS and Treasury have commented publicly that §909 is drafted broadly enough to be considered a core principle of the foreign tax credit, not merely an anti-abuse provision. If such an approach had been followed in the regulations, it would have been highly destabilizing. All manner of minor discrepancies between U.S. and foreign law (e.g., such-and-such a payment is deductible in the U.S. but capitalizable in Country X) would have been converted into FTCSEs. The IRS and Treasury are thus to be commended for the measured approach of applying §909 to only four types of arrangements, as discussed below. Future guidance may add new FTCSEs to the list on a prospective basis, but one can hope that this will not become necessary. In their current form, at least, the 2012 Regulations allow taxpayers to identify with relative ease, and thus to avoid or manage, transactions that give rise to FTCSEs.

The 2012 Regulations do expand the statutory definition of a FTCSE in one respect. Based on the text of §909, a FTCSE occurs with respect to a foreign income tax if the related income ''is (or will be)'' taken into account by a covered person.[47] The 2012 Regulations expand the definition to encompass situations in which related income ''was'' taken into account by a covered person.[48] According to the IRS and Treasury, the parenthetical was never intended to preclude a FTCSE from arising where the related income accrues before the foreign tax. This rule does not appear to have broad application for the current list of splitters, but it may indicate that the IRS and Treasury are thinking about adding splitters for which the language could be relevant.

The Preamble to the 2012 Regulations states that the government intends to issue future guidance on how to calculate the related income and split taxes attributable to a FTCSE.[49] Until that guidance comes out, related income and split taxes are determined using the rules from Notice 2010-92,[50] except that the ''related-income-first-out'' (''RIFO'') method of extracting related income no longer helps taxpayers accelerate the release of split foreign taxes.[51] Going forward, distributions and other inclusions from the covered person are treated as coming pro rata out of related income and other income.[52] The RIFO rule now applies only to identify the opening balance of a §902 corporation's suspended split taxes in its first post-2010 taxable year, and even then only by election.[53]

Categories of Foreign Tax Credit Splitting Events

The 2012 Regulations identify three main categories of FTSCEs going forward: (1) reverse hybrid splitter arrangements; (2) loss-sharing splitter arrangements; and (3) hybrid instrument splitter arrangements. While the rules relating to reverse hybrid splitter arrangements and hybrid instrument splitter arrangements are largely the same as they were in Notice 2010-92, the rules relating to loss-sharing splitter arrangements have been substantially revised. A fourth potential category of FTCSE, relating to dis-

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[43] *See, e.g.,* Rev. Rul. 78-83, 1978-1 C.B. 79 (holding that a transfer of property to a sister corporation results in a constructive dividend to the common parent followed by a capital contribution to the sister corporation, unless the transfer is in exchange for consideration); Rev. Rul. 73-605, 1973-2 C.B. 109 (holding that where a subsidiary makes a payment to common parent (P) in excess of the subsidiary's share of the group's tax liability, the payment is a dividend to P followed by a capital contribution from P to a sister subsidiary that has surrendered a tax loss to the group); PLR 200225032 (stating that to the extent that payments from subsidiaries exceed the amount of taxes due, such payments generally are treated as dividends from the subsidiaries to the parent company to the extent of E&P); T.D. 9576, 77 Fed. Reg. 8120, 8123 (2/14/12) (stating that a shareholder's payment of tax on behalf of its corporation ordinarily results in a deemed capital contribution and a deemed payment of tax by the corporation for U.S. tax purposes).

[44] Regs. §1.901-2(h)(4).

[45] *Id.*

[46] *See* 77 Fed. Reg. at 8124.

[47] §909(d)(1).

[48] Regs. §1.909-2T(a)(1).

[49] 77 Fed. Reg. at 8133.

[50] Regs. §1.909-3T(a). The 2012 Regulations adopt these rules at Regs. §1.909-6T(d) through (f).

[51] *See* 77 Fed. Reg. at 8133.

[52] *See* Regs. §1.909-6T(d)(3).

[53] *See* Regs. §1.909-6T(d)(4).

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regarded payments between branches of a partnership, generally has been addressed going forward by changes to the §704(b) allocation rules.[54]

Reverse Hybrid Splitter Arrangements

The 2012 Regulations adopt the reverse hybrid splitter arrangement with virtually no changes from Notice 2010-92. A reverse hybrid splitter arrangement occurs when a taxpayer pays a foreign income tax with respect to the income of a reverse hybrid.[55] The foreign tax paid with respect to the income of the reverse hybrid is the split tax, which is suspended until the related income is taken into account.[56] The related income is the E&P (computed for U.S. purposes) of the reverse hybrid that is attributable to the activities that gave rise to the income with respect to which the split taxes were paid.[57] The amount of related income adjusts over time based on income or loss within the ''splitter system'' — that is, income or loss from the activities of the reverse hybrid subject to tax under foreign law.[58]

Loss-Sharing Splitter Arrangements

The 2012 Regulations broaden somewhat the coverage of the loss-sharing splitter arrangement relative to Notice 2010-92. Under Notice 2010-92, this type of FTCSE generally arose when interest on a disregarded debt instrument produced a loss that was then shared out to a person related to the owner of the instrument.[59] The concept was that the loss should have been shared with the owner of the instrument, and a splitter arose to the extent it was instead shared with another person. The 2012 Regulations generalize this rule to fit fact patterns beyond disregarded debt. Under the 2012 Regulations, a loss-sharing splitter arrangement generally occurs when a shared loss of a ''U.S. combined income group'' could have been used to offset income of that group (a ''usable shared loss'') but instead is used to offset the income of another such group.[60]

A U.S. combined income group is a single individual or corporation (U.S. or foreign), along with any entity that for U.S. tax purposes combines its items of income, deduction, gain, or loss with the individual or corporation.[61] An entity can belong to more than one U.S. combined income group, but a U.S. combined income group cannot include more than one individual or corporation. For example, a CFC and its DEs would form one combined income group. If the CFC also owns a partnership interest, then its combined group includes its allocable share of items from the partnership. In either case, a FTCSE occurs when a member of the U.S. combined income group shares a loss outside the group instead of using it to offset income within the group. If no other group member has income in the relevant year, no FTSCE should result.

Example.[62] USP owns CFC1, which owns CFC2 and CFC3. CFC2 owns DE, which is a corporation for foreign tax purposes and a disregarded entity for U.S. federal income tax purposes. CFC2 and CFC3 each own 50% of HP1, which is a corporation for foreign tax purposes and a partnership for U.S. federal income tax purposes. All items of income and loss of HP1 are allocated equally between CFC2 and CFC3 for U.S. federal income tax purposes. Foreign law imposes tax of 30% on the taxable income of all foreign corporations. In Year 1, CFC2 has income of 100, CFC1 and CFC3 have no income, DE has a loss of 100, and HP1 has income of 200. Under a foreign loss-sharing regime, the group decides to use DE's loss to offset 100 of HP1's income.

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[54] *See* 77 Fed. Reg. at 8129–30.

[55] Regs. §1.909-2T(b)(1)(i).

[56] Regs. §1.909-2T(a) and (b)(1)(ii).

[57] Regs. §1.909-2T(b)(1)(iii).

[58] Regs. §1.909-6T(d)(1).

[59] *See* Notice 2010-92, §4.04, 2010-52 I.R.B. at 919.

[60] Regs. §1.909-2T(b)(2)(i). A shared loss is a loss of one entity under foreign law that is taken into account by another entity in connection with a foreign group relief or other loss-sharing regime. Regs. §1.909-2T(b)(2)(iii)(B). A foreign group relief or other loss-sharing regime generally exists when an entity may surrender its loss to offset the income of one or more other entities. Regs. §1.909-2T(b)(2)(vi).

[61] Regs. §1.909-2T(b)(2)(ii). For purposes of §909, a branch is treated as an entity, and all members of a U.S. consolidated group are treated as a single corporation. *Id.*

[62] *See* Regs. §1.909-2T(b)(2)(vii), *Ex. 2*.

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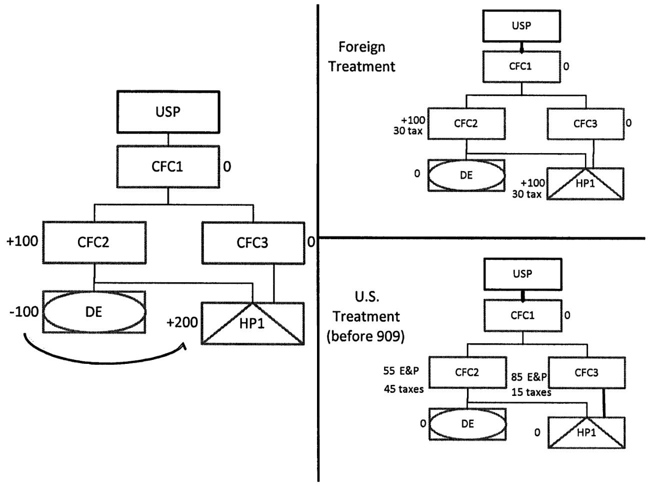
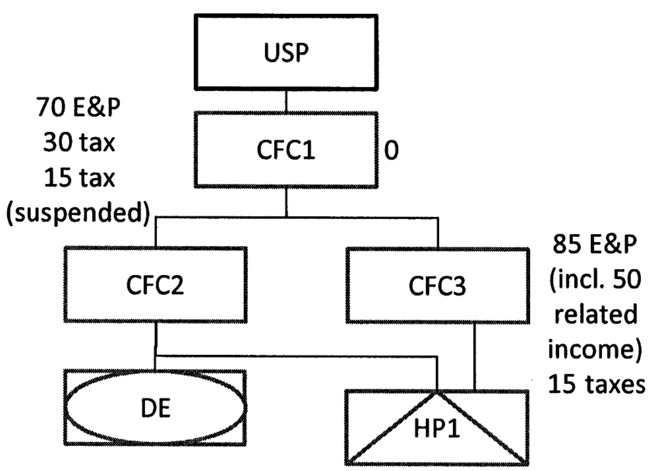
Pre-§909 Treatment



Pre-909 Treatment. For purposes of foreign law, CFC2 and HP1 each have income of 100, upon which they pay 30 of foreign tax. For U.S. federal income tax purposes, however, the loss sharing with HP1 is not taken into account. Because DE is a disregarded entity, the DE loss is taken into account by CFC2. HP1's income of 200 is allocated 50/50 between CFC2 and CFC3, as is the 30 of foreign tax paid by HP1. Accordingly, before applying §909, CFC 2 would have E&P of 55 (100 of income + 100 of HP1's income – 100 of DE's loss – 30 of foreign income tax paid by CFC2 – 15 of income tax paid by HP1) and 45 of foreign income tax. CFC3 has E&P of 85 (100 of HP1's income – 15 of income tax paid by HP1) and 15 of foreign income tax.

U.S. Treatment After §909



Post-909 Treatment. Under the 2012 Regulations, CFC2, DE, and half of HP1 are one combined group, while CFC3 and the other half of HP1 are a separate group.[63] The income of the CFC2 group is 200, based on 100 of CFC2's own income and 100 allocated from HP1 for U.S. federal income tax purposes.[64] The income of the CFC3 group is 100, based on the allocation from HP1 for U.S. federal income tax purposes. The shared loss of the CFC2 group is –100. The usable shared loss of the CFC2 group is also –100, based on the amount of DE's loss that could have been used under foreign law to offset income of CFC2. A FTCSE exists to the extent that the –100 usable shared loss was used to offset the income of the CFC3 group. The split taxes with respect to the FTCSE are the 15 of foreign taxes paid by CFC2 on the 50 of income that its share of the usable shared loss could have offset. Related income is the 50 of CFC3's income that equals the amount of income offset by the shared loss.[65]

Under the 2012 Regulations, a combined income group has to have a usable shared loss in order for a loss-sharing FTCSE to arise. For this reason, loss-sharing FTCSEs, at least as currently defined, would appear to arise only where hybrid entities are involved. If a standalone CFC incurs a loss, the loss cannot be shared out to another member of the combined income group (there are none) and so cannot be a usable shared loss. Hybridity is therefore the place to look for loss-sharing FTCSEs.

On a related point, a loss-sharing FTCSE does not appear to arise under the 2012 Regulations solely from the use of losses by the same entity on a carryover basis. For example, if standalone CFC1 shares its loss with CFC2, a FTCSE does not arise merely because CFC1 has positive taxable income the following year, against which CFC1 could have offset its loss if it had kept it and carried it forward. The loss incurred in the first year is not a usable shared loss. This result makes sense from the perspective of administrability, but the IRS nevertheless appears to be giving this issue further thought.

Hybrid Instrument Splitter Arrangement

The 2012 Regulations describe two types of hybrid instrument splitter arrangements: U.S. equity hybrid instrument splitter arrangements (a "hybrid-equity FTCSE") and U.S. debt hybrid instrument splitter arrangements. The definitions of these FTCSEs in the 2012 Regulations generally are the same as those in Notice 2010-92. However, the definition of "hybrid

[63] The regulations provide special rules for computing shared losses and foreign taxable income where a member of a U.S. combined income group is a member of more than one such group. *See* Regs. §1.909-2T(b)(2)(iii)(B). Generally speaking, if the entity is not fiscally transparent under foreign law, then the entity's shared loss or foreign taxable income is allocated among the groups based on U.S. tax principles. In the case of a hybrid partnership, for example, the partnership's shared loss or foreign taxable income is allocated among the groups in the same manner as the partnership allocates those items under §704(b). If the entity is fiscally transparent under foreign law, then the entity's shared loss or foreign taxable income is allocated among the groups based on foreign tax principles.

[64] U.S. combined group income consists of the aggregate taxable income of members with positive taxable income, computed under foreign law. Regs. §1.909-2T(b)(2)(iii)(A).

[65] *See* Regs. §1.909-2T(b)(2)(vii), *Ex. 2*.

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equity'' that can give rise to a hybrid-equity FTCSE now includes equity that benefits from a notional interest deduction.[66] Under Notice 2010-92, the instrument had to be treated as debt for foreign purposes, but that is no longer the case.

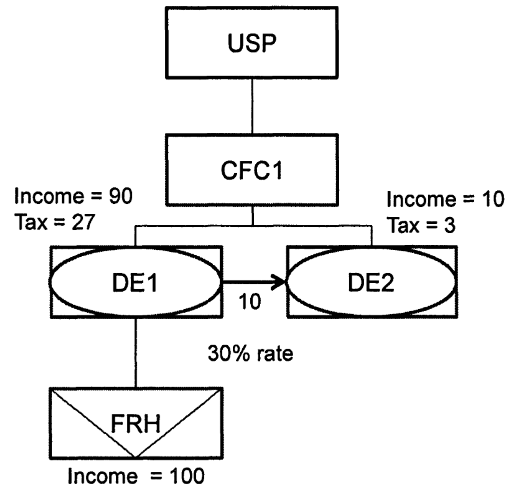
In more general terms, a hybrid-equity FTCSE arises if payments or accruals with respect to a hybrid-equity instrument: (1) give rise to foreign income taxes paid or accrued by the instrument's owner; (2) are deductible by the issuer under foreign law; and (3) do not give rise to income for U.S. federal income tax purposes.[67] Split taxes with respect to a hybrid-equity FTCSE equal the total amount of foreign income taxes paid by the owner of the instrument, less the amount of foreign income taxes that the owner would have paid if income from the instrument had not been subject to foreign tax.[68] Related income is income of the issuer in an amount equal to the deductible payments giving rise to the split foreign taxes.[69]

An instrument that pays interest currently for foreign purposes and also pays dividends currently for U.S. purposes should not meet the third prong of the hybrid-equity FTCSE definition because the instrument *does* give rise to income for U.S. federal income tax purposes. This result is consistent with the Joint Committee Report issued when §909 was enacted.[70] The report confirms that a hybrid-equity FTCSE arises when *no* income is recognized for U.S. tax purposes, for example, because the holder accrues interest on the instrument but does not currently receive payment of that interest, which would be treated for U.S. purposes as a dividend when paid. Nevertheless, the IRS and Treasury appear to be at least contemplating treating instruments that pay dividends currently for U.S. purposes as hybrid-equity FTCSEs, but then treating the dividend payments as potential payments of related income. The more easily administrable approach would be simply to leave such instruments outside the scope of §909, but, if not, this situation might present an appropriate occasion for a RIFO rule. The related income should come out first and spring the split tax at the holder in the same year.

Disregarded Payments

In addition to the three categories of FTCSEs described above, the 2012 Regulations include a new rule that applies to certain disregarded payments among related entities.[71] Under the new rule, split taxes include any foreign taxes paid or accrued after 2010 with respect to a disregarded payment that is deductible by the payor under foreign law, so long as the payor is subject to foreign tax on related income from a splitter arrangement.[72]

Example. USP owns CFC1, which owns DE1 and DE2. DE1 owns FRH, a foreign reverse hybrid. FRH earns income of 100, on which DE1 ordinarily would pay 30 of foreign tax. However, DE1 pays interest of 10 to DE2, which reduces DE1's income from 100 to 90 and which increases DE2's income from 0 to 10. Consequently, DE1 pays 27 of foreign tax, not 30, and DE2 pays 3 of foreign tax. Under the 2012 Regulations, the full 30 remains a split foreign tax, even though DE2 does not own an interest in FRH.



In effect, this provision creates a stacking rule, in which the first dollar of a disregarded payment shifts the split tax to the recipient of the payment, even if the payor has other income from which the disregarded payment could have been made. The amount of the disregarded payment to which the rule applies is limited to the amount of related income from the associated splitter arrangement.

"The Tractor"

As noted above, a fourth potential category of FTCSE, relating to disregarded payments between branches of a partnership, has been addressed by changes to the §704(b) allocation rules.[73] Under those rules, the allocation of creditable foreign tax expenditures (CFTEs) generally must be made in proportion to the distributive shares of partnership income to which the taxes relate.[74] The regulatory safe harbor still can apply if, for example, a geographic allocation

[66] 77 Fed. Reg. at 8132.

[67] Regs. §1.909-2T(b)(3)(i)(A).

[68] Regs. §1.909-2T(b)(3)(i)(B).

[69] Regs. §1.909-2T(b)(3)(i)(C).

[70] Joint Comm. on Tax'n, 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 Aug. 10, 2010, at 6 (2010).

[71] Regs. §1.909-3T(b).

[72] *Id.* The anti-abuse rule applies with respect to taxable years beginning after 2010. Regs. §1.909-3T(c).

[73] *See* Regs. §§1.704-1(b)(4)(viii)(*c*)(*3*)(*ii*), -1T(b)(5), *Ex. 24*.

[74] *See* Regs. §1.704-1(b)(4)(viii)(*a*). CFTEs are allocated among a partnership's CFTE categories, which are categories of net income or loss attributable to one or more activities of the partnership. In general, a separate CFTE category exists for one or more activities of the partnership to the extent that the allocation of income or loss from such activities differs from the allocation of income or loss from other activities. Regs. §1.704-

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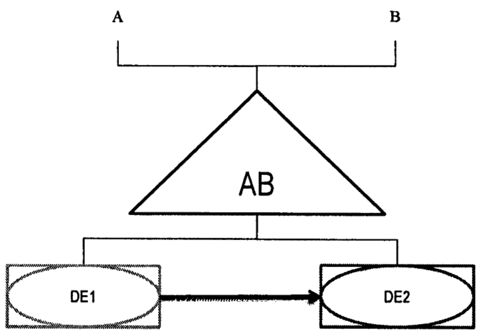
of partnership income results in one partner receiving income and taxes from a high-tax jurisdiction, while another partner receives income and taxes from a low-tax jurisdiction.[75]

Until the 2012 Regulations, taxpayers could affirmatively create this type of low-tax, high-tax split using disregarded payments between DEs owned by the partnership.[76] Although the disregarded payment resulted in the separation of income from credit, an example in the regulations under §704(b) accepted this result.[77] The resulting structure looks like a tractor, viewed from above — and thus a nickname was born.



Under the old §704(b) safe harbor, A and B might have agreed that A would receive a larger allocation than B of income and foreign taxes from the DE1 business (in Country A), and that they would split equally the income and foreign taxes from the DE2 business (in Country B). Given this allocation, the effect of a disregarded payment of interest from DE1 to DE2 would have been to increase the effective rate of foreign tax imposed on the DE2 business, without changing the income allocation from a U.S. tax perspective. Thus, the effect of the payment would have been to separate a portion of the income allocated to A from the foreign taxes allocated to B.

Under the 2012 Regulations, the taxes imposed on the disregarded payment now must be allocated to the related income. The regulatory safe harbor is satisfied if the foreign taxes and the related income are allocated in the same ratios. In very general terms, this can be accomplished in one of two ways: either the additional tax arising at DE2 from the disregarded payment can be allocated back to the CFTE category of DE1,[78] or the partners can change their income allocation so that the disregarded payment matches the allocation applicable to DE2.[79] Either way, the tax on the disregarded payment is matched to the related income.

If the allocation does not follow the safe harbor, then §909 applies and creates a FTCSE.[80] In this situation, the split foreign taxes are the extra taxes allocated to a partner from the disregarded payment, relative to what would have been allocated if those taxes had been allocated in accordance with income. The related income is the extra income allocated to a partner, relative to the amount that would have been allocated had income in the amount of the disregarded payment been allocated in accordance with the tax. The regulations provide a transition rule for partnership agreements that were entered into before February 14, 2012,[81] but the transition rule does not allow any splitter benefits going forward.

Section 901(m)

The 2012 Regulations helpfully provide that §901(m) covered asset acquisitions are excluded from the list of arrangements that give rise to FTCSEs.[82] This exclusion is important because it mitigates the risk that the post-2010 effects of a pre-2011 §901(m) acquisition could give rise to a FTCSE. The main downside of this decision is that if the IRS and Treasury had chosen to apply §909 instead of §901(m) to related-party covered asset acquisitions, then taxpayers claiming a credit might have been able to release the taxes caught up in this type of splitter. As it stands, §901(m) applies and permanently denies the credit. Nevertheless, considerable complexity was averted by the approach chosen.

Section 901(m) still can apply to taxes paid in connection with a FTCSE, albeit in rare cases. One example is the acquisition of a reverse hybrid in which a §338 election is made.[83] In such a case, the credit for foreign taxes may be denied and the deduction for those taxes also may be suspended.

Effective Dates

The definitions of FTCSEs in the 2012 Regulations generally apply to foreign taxes paid or accrued in taxable years beginning after 2011.[84] The 2012 Regulations also provide transition rules that detail the application of the regulations to foreign taxes paid or accrued in taxable years beginning in 2011. In general, foreign income taxes paid in 2011 in connection with pre-2011 splitter arrangements are split taxes to the same extent that they would have been if paid or accrued by a §902 corporation before 2011.[85] However, there are special transition rules for foreign consolidated groups[86] and Tractor structures.[87] The following chart shows what transactions are treated as FTC-

1(b)(4)(viii)(*c*)(*1*) and (*2*)(*i*).

[75] *See, e.g.,* Regs. §1.704-1(b)(5), *Ex. 21*.

[76] *See* former Regs. §1.704-1(b)(4)(viii)(*d*)(*3*), prior to amendment. Notice 2010-92 warned that this structure would be addressed by the 2012 Regulations.

[77] *See* former Regs. §1.704-1(b)(5), *Ex. 1*, prior to amendment.

[78] *See* Regs. §1.704-1T(b)(5), *Ex. 24(i)–(ii)*.

[79] *See id.*, *Ex. 24(iii)*.

[80] *See* Regs. §1.909-2T(b)(4).

[81] *See* Regs. §1.704-1T(b)(1)(ii)(*b*)(*3*)(*B*).

[82] 77 Fed. Reg. at 8131.

[83] *Id.*

[84] Regs. §1.909-2T(c).

[85] Regs. §1.909-5T(a)(1).

[86] *See* Regs. §1.909-5T(b); 77 Fed. Reg. at 8121–22, 8134.

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SEs under Notice 2010-92 and the 2012 Regulations:

[87] Regs. §1.909-5T(a)(2); 77 Fed. Reg. at 8124, 8134.

Foreign Taxes Paid or Accrued in Years Beginning Before 2011	Foreign Taxes Paid or Accrued in Years Beginning During 2011	Foreign Taxes Paid or Accrued in Years Beginning After 2011
Reverse Hybrids	Reverse Hybrids	Reverse Hybrids
Hybrid Instruments	Hybrid Instruments	Hybrid Instruments (including notional interest)
Group Relief from Disregarded Payments	Group Relief from Disregarded Payments	Group Relief from Usable Shared Losses
Foreign Consolidated Groups	Foreign Consolidated Groups that do not elect to apply the final technical taxpayer regulations	Foreign Consolidated Groups in taxable years beginning on or before February 14, 2012 that do not elect to apply the final technical taxpayer regulations
	Tractor structures unless the tax is allocated with the income of the payor of the disregarded payment.	Tractor structures under a special transition rule (generally between 10 and 50% related ownership) that allows use of old safe harbor. Outside the transition rule, trying to follow the old safe harbor does not satisfy §704(b).

FUTURE GUIDANCE

The IRS and Treasury warned in the Preamble to the 2012 Regulations that they may expand prospectively the list of FTCSEs. For example, they said they are scrutinizing arrangements that result in the separation of foreign income taxes and related income because of timing differences in the recognition of dividend income.[88] One such arrangement, they noted, occurs when a distribution is treated as a dividend for foreign tax purposes but either is excludible from the shareholder's gross income under §305(a) or is disregarded for U.S. purposes. This would make such arrangements similar to hybrid-equity FTCSEs, but without the hybrid instrument. For example, in Rev. Rul. 80-154,[89] capitalized business profits of a foreign corporation were taxable under foreign law as dividends paid to the corporation's shareholders but were treated for U.S. purposes as non-taxable stock dividends. Similarly, in Rev. Rul. 83-142,[90] a payment from a foreign corporation to its shareholder as part of a circular flow of cash was disregarded for U.S. federal income tax purposes, even though it was treated as a dividend subject to withholding tax under foreign law. An IRS official has commented that such cases are of concern because they give rise to timing differences that are not certain to reverse.

The IRS and Treasury are also looking at certain types of asset transfers that can create differences in the timing of income inclusions or the calculation of basis.[91] For example, an IRS official has indicated that they are examining situations in which a bond is sold halfway through an accrual period, at the end of which the interest is paid and subjected to a foreign withholding tax. The same official commented that the IRS is sensitive to the administrative concerns with adding to the list of FTCSEs, but that they will continue to focus on situations where the separation of income and credit is not likely to reverse — and particularly where the taxpayer can control whether and when it does.

Regarding scheduled guidance, the IRS and Treasury are continuing their work on a very detailed §901(m) notice. They also have indicated in public comments that they plan to release another tranche of guidance under §909 dealing with topics such as the mechanics of calculating related income and split taxes.

[88] *See* 77 Fed. Reg. at 8131.

[89] 1980-1 C.B. 68.

[90] 1983-2 C.B. 68.

[91] 77 Fed. Reg. at 8131.

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