

December 14, 2010

Foreign Tax Credit “Splitter” Arrangements

IRS Issues Initial Guidance on Section 909

SUMMARY

On December 6, 2010, the Internal Revenue Service (the “IRS”) issued Notice 2010-92 (the “Notice”), which provides guidance on aspects of Section 909, a provision that was added to the Internal Revenue Code in August 2010. Section 909 defers the creditability of foreign taxes that are paid in connection with so-called “foreign tax credit splitter” arrangements: that is, structures that separate the person liable for the foreign tax from the person entitled to the related income and, under pre-Section 909 law, might allow a credit for the foreign tax in a year prior to the year, if any, in which the related income is taken into account for U.S. federal income tax purposes.

In general, Section 909 is not retroactive and does not apply to foreign taxes that were paid or accrued in taxable years beginning on or before December 31, 2010 (“Pre-Effective Taxable Years”). However, Section 909 applies to foreign taxes that were accrued or paid in earlier periods (taxes that are paid or accrued in an earlier period, hereafter “Legacy Taxes”; and those Legacy Taxes that are subject to Section 909, hereafter, “Suspended Legacy Taxes”) to the extent that a corporate 10% U.S. shareholder of a foreign corporation claims an “indirect” foreign tax credit for Legacy Taxes of the corporation in a taxable year beginning after December 31, 2010 (a “Post-Effective Taxable Year”). In other words, beginning with the foreign corporation’s first Post-Effective Taxable Year, the provision generally applies to the “pool” of foreign taxes for which a corporate U.S. shareholder may claim a foreign tax credit even if those foreign taxes were paid or accrued in a Pre-Effective Taxable Year. Because of this potential retrospective effect, a taxpayer with an arrangement that may be affected by the Notice should review the foreign taxes of any entities that could potentially be subject to Section 909 before the end of its final Pre-Effective Taxable Year.

The Notice identifies four types of “Pre-2011 Splitter Arrangements” that will be the sole arrangements giving rise to Suspended Legacy Taxes:

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- Certain structures involving “reverse hybrids” (*i.e.*, entities that are fiscally transparent for local non-U.S. tax purposes, but treated as corporations for U.S. federal income tax purposes);
- Foreign consolidated groups in which foreign taxes were not, for U.S. federal income tax purposes, apportioned by taxpayers among the members in accordance with their shares of the foreign income of the group;
- Arrangements involving certain “disregarded debt instruments” (*i.e.*, obligations that have no effect for U.S. federal income tax purposes, but are treated as indebtedness under local law); and
- Certain structures involving hybrid instruments (*i.e.*, instruments that are characterized as equity for U.S. federal income tax purposes, but as indebtedness under local non-U.S. tax law, or vice versa).

In addition to creating Suspended Legacy Taxes, these four structures will, according to the Notice, be foreign tax credit splitting events in Post-Effective Taxable Years. Future guidance may also treat other arrangements as splitting events with respect to foreign taxes paid or accrued in Post-Effective Taxable Years. The Notice also provides that Legacy Taxes paid or accrued by a foreign corporation in a taxable year beginning before January 1, 1997 will not be treated as Suspended Legacy Taxes. Accordingly, a taxpayer claiming indirect foreign tax credits will need to review taxes paid by a foreign subsidiary since the beginning of that subsidiary’s first taxable year that started in 1997, but will not need to go back further.

The Notice describes detailed rules that will govern the treatment of Suspended Legacy Taxes, including:

- A determination that Legacy Taxes that exceed a taxpayer’s foreign tax credit limitation in a separate category and are carried forward under Section 904(c) will not be subject to Section 909;
- Initial rules that specify how Suspended Foreign Taxes and related income will be accounted for under Section 909 (including rules governing how partnerships and trusts will need to apply Section 909); and
- Preliminary rules governing the application of Section 909 to other parts of the Internal Revenue Code (*e.g.*, the deductibility of foreign taxes, statute of limitations provisions and provisions governing redeterminations of foreign tax amounts).

BACKGROUND

A. FOREIGN TAX CREDIT “SPLITTER” ARRANGEMENTS

U.S. federal income tax law has generally treated a taxpayer as having paid a foreign tax if, under foreign law, the taxpayer was legally liable for the foreign tax: the so-called “technical taxpayer” rule.¹ As a consequence, under pre-Section 909² law, the time when the foreign tax is deemed paid under foreign law (and accordingly, the time at which a taxpayer may be entitled to claim a U.S. foreign tax credit for that tax) may differ from the time when the underlying income is taken into account for U.S. federal

¹ See Treas. Reg. § 1.901-2(f).

² Unless otherwise noted, all Section references contained in this publication are to the Internal Revenue Code of 1986, as amended.

income tax purposes. In response to perceived deficiencies in this rule,³ the Treasury Department published proposed regulations in 2006⁴ that, if finalized, would have modified the technical taxpayer rule to address the allocation of foreign taxes paid by a group that filed consolidated returns under foreign law, and to address foreign tax credits taken by the owner of a “reverse hybrid” (the “2006 Proposed Regulations”). The IRS announced, in the Notice, that it does not intend to finalize the portion of the 2006 Proposed Regulations that relates to the foreign taxes and income of reverse hybrids, and is re-evaluating the remainder of the 2006 Proposed Regulations.

B. SECTION 909

Section 909, which was enacted in August 2010, is intended to eliminate the tax benefits of “foreign tax credit splitting events” (*i.e.*, transactions where, for U.S. federal income tax purposes, foreign income taxes are paid by one person, the associated income is—in whole or in part—income of another person, and the associated income is not taken into account by that other person in the year in which the foreign tax is paid or accrued). It does this through a “matching rule” that suspends the availability of foreign tax credits until the related income is taken into account for U.S. federal income tax purposes. Specifically, Section 909 provides that a “foreign tax credit splitting event” occurs if a foreign taxpayer is treated as paying a foreign income tax that relates to income that would be taken into account (for U.S. federal income tax purposes) by a “covered person.” Under Section 909, a “covered person” is any: (i) direct or indirect owner of 10% or more of a person that is treated as paying a foreign tax (the “Payor”); (ii) person owned 10% or more by a Payor; (iii) person related to the Payor;⁵ or (iv) other person identified in guidance issued by the Treasury Department as a “covered person.”

³ For example, in *Guardian Industries v. United States*, 65 Fed. Cl. 50 (Ct. Cl. 2005); *aff'd*, 477 F.3d 1368 (Fed. Cir. 2007), the IRS challenged a transaction in which a U.S. parent of a Luxembourg unitary group claimed a foreign tax credit through its Luxembourg holding company, which was treated as disregarded from its U.S. parent for U.S. federal income tax purposes. Under Luxembourg law, the holding company was solely liable for the tax of the entire unitary group, and the taxpayer asserted that it was entitled to claim a U.S. foreign tax credit for the entire amount of Luxembourg tax that was paid, even though some of the income on which that tax was incurred remained in the holding company's subsidiaries (and outside the scope of the U.S. tax net until it was distributed). The taxpayer in *Guardian Industries* was successful both at trial and on appeal. For a further discussion of the *Guardian Industries* case, please see the Sullivan & Cromwell LLP publication entitled “*Guardian Industries v. United States* Sustains Taxpayer's Claim for Direct Foreign Tax Credit” (Apr. 25, 2005), which may be obtained by following the instructions at the end of this publication.

⁴ See Prop. Treas. Reg. § 1.901-2(f), 71 Fed. Reg. 44,240 (Aug. 4, 2006). For further discussion of the 2006 Proposed Regulations, please see the Sullivan & Cromwell LLP publication entitled “Definition of Taxpayer for Purposes of the FTC Rules: IRS Issues Proposed Regulations on the Definition of a ‘Taxpayer’ for Foreign Tax Credit Purposes” (Aug. 9, 2006), which may be obtained by following the instructions at the end of this publication.

⁵ Whether a person is “related” is determined under the rules of Section 267(b) or 707(b).

DISCUSSION

The Notice focuses on rules related to Legacy Taxes, but also requests public comment regarding how Section 909 may be applied to foreign taxes paid in the future. The IRS and Treasury Department anticipate issuing regulations that incorporate the guidance set forth in the Notice.

The Notice identifies four arrangements that will constitute the “exclusive list” of Pre-2011 Splitter Arrangements:

- Certain “reverse hybrid” structures;
- Certain foreign consolidated groups;
- Certain “disregarded debt instruments”; and
- Arrangements involving certain hybrid instruments.

In addition to being treated as Pre-2011 Splitter Arrangements, these structures, together with others that may be identified in future guidance, will be “foreign tax credit splitting events” that are subject to the Section 909 deferral rules on a going-forward basis.⁶

A. EXCLUSIONS

According to the Notice, the IRS and Treasury Department intend to issue regulations providing that Legacy Taxes that were incurred in a Pre-2011 Splitter Arrangement and were paid or accrued in a taxable year of a “Section 902 Corporation”⁷ beginning before January 1, 1997 will not be suspended under Section 909.⁸ In addition, the following Legacy Taxes will not be subject to the deferral rules of Section 909:

- Legacy Taxes that were not paid or accrued in the four Pre-2011 Splitter Arrangements identified in the Notice;
- Legacy Taxes that were incurred in connection with a Pre-2011 Splitter Arrangement but that are deemed paid under Section 902(a) or Section 960 on or before the final day of the Section 902 Corporation’s last Pre-Effective Taxable Year; and

⁶ As discussed in additional detail below, the IRS has requested comments on whether several other arrangements should be treated as “foreign tax credit splitting events.” However, if other types of structures or circumstances are identified as “foreign tax credit splitting events,” this identification will be made on a prospective basis, and such arrangements will not be treated as Pre-2011 Splitter Arrangements.

⁷ A “Section 902 Corporation” is defined in Section 909(d)(5) as a foreign corporation with respect to which one or more domestic corporations meets the ownership requirements of Section 902(a) or Section 902(b): that is, a foreign corporation whose foreign taxes could potentially be claimed by a U.S. corporate shareholder for an “indirect” foreign tax credit.

⁸ This date is earlier than some commentators had recommended. For example, the American Bar Association Section of Taxation suggested by analogy to the anticipated effective date of the 2006 Proposed Regulations that Legacy Taxes that were paid in a taxable year beginning before January 1, 2007 be excluded from the application of Section 909. See Am. Bar Ass’n, Section of Taxation. Comments on the Effective Date of Section 909 (Nov. 15, 2010), at 8.

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- Legacy Taxes that were incurred in connection with a Pre-2011 Splitter Arrangement if either: (i) the Payor Section 902 Corporation took the related income into account in a Pre-Effective Taxable Year; or (ii) a domestic corporation that meets the ownership requirements of Section 902 (a) or (b) with respect to a Section 902 Corporation (a “Section 902 Shareholder”) took the related income into account on or before the last day of the Payor Section 902 Corporation’s last Pre-Effective Taxable Year.

B. PRE-2011 SPLITTER ARRANGEMENTS

1. Reverse Hybrid Structures

Under the Notice, a “reverse hybrid” structure will be a Pre-2011 Splitter Arrangement if Legacy Taxes were paid or accrued by a Section 902 Corporation with respect to income of a “reverse hybrid” that is a covered person, with respect to the Section 902 Corporation. A “reverse hybrid” structure is an arrangement in which an entity is treated as a corporation for U.S. federal income tax purposes, but is classified as a branch or pass-through entity under local non-U.S. law. As a consequence, the income of the reverse hybrid is treated, under U.S. tax principles, as income of the entity and may not be subject to current U.S. tax, but the taxpayer—*i.e.*, the person liable for the foreign tax on the income—is the owner of the reverse hybrid.

Reverse hybrid arrangements were addressed differently in the 2006 Proposed Regulations, and in light of this different approach, the Notice says that the IRS will not finalize the part of the 2006 Proposed Regulations relating to reverse hybrids. Under the 2006 Proposed Regulations, the foreign tax, instead of being suspended until matched with the income to which it related, was generally allocated to the reverse hybrid itself.

2. Certain Foreign Consolidated Groups

The Notice identifies foreign consolidated groups⁹ as Pre-2011 Splitter Arrangements to the extent that the foreign tax liability was not allocated for U.S. federal income tax purposes in proportion to each member’s share of the base on which the group pays the foreign tax. Under Treasury Regulations Section 1.901-2(f)(3), foreign taxes that are imposed on the combined income of multiple related persons must be apportioned in such a manner, but only where foreign law imposes joint and several liability.¹⁰

Foreign consolidated groups may be Pre-2011 Splitter Arrangements even if one or more members of a foreign consolidated group have an earnings and profits deficit for a particular year. The Notice provides that Legacy Taxes paid on account of the income of a foreign consolidated group that constitutes a Pre-2010 Splitter Arrangement will be treated as Suspended Legacy Taxes to the extent that taxes paid or

⁹ Under the notice, a “foreign consolidated group” exists when, under local law, tax is imposed on the combined income of two or more entities.

¹⁰ Accordingly, Treasury Regulations Section 1.902-2(f)(3) does not apply to foreign consolidated groups if, for example, a common parent is solely liable for the tax of the group. The 2006 Proposed Regulations would have modified this rule by removing the “joint and several liability” requirement.

accrued by one member of the group are imposed on a covered person's portion of the consolidated taxable income included in the foreign tax base. The associated earnings and profits, determined under U.S. federal income tax principles, will constitute the related income that is associated with such a Suspended Legacy Tax.

3. Arrangements Involving "Disregarded Debt Instruments"

Some non-U.S. jurisdictions have "group relief" mechanisms that may permit entities with losses to surrender their losses to offset the income of related entities. The Joint Committee on Taxation Report on Section 909 specifically identified group relief mechanisms and "disregarded payments" as potentially subject to Section 909.¹¹

In identifying Pre-2011 Splitter Arrangements, the Notice takes a relatively narrow approach to "group relief" mechanisms, and only treats a group relief regime as giving rise to a Pre-2011 Splitter Arrangement if it involves a "disregarded debt instrument" (*i.e.*, an instrument that is treated as debt under the law of the country where the issuer is subject to tax, but that is disregarded for U.S. federal income tax purposes). In particular, a "shared" loss can constitute a Pre-2011 Splitter Arrangement if three conditions are met:

- There is a disregarded debt instrument;¹²
- The holder of the disregarded debt instrument pays a foreign tax that is attributable to a payment or accrual on that debt instrument; and
- The payment or accrual on the disregarded debt instrument gives rise to a deduction under local tax law, and the issuer of the instrument incurs a shared loss that is taken into account under local law by one or more parties that is a covered person with respect to the owner of the disregarded debt instrument.

For example, suppose a U.S. subsidiary of a foreign corporation had two foreign subsidiaries, each a disregarded entity; that one made a loan to the other, creating a loss in the borrower equal to the interest expense on the loan and a foreign tax liability for the lender, and that the loss was surrendered to the foreign parent of the U.S. subsidiary, which reduces its foreign tax liability. Absent Section 909, the loss would, in effect, shift the local tax liability of the foreign parent to the lender (and thus to the U.S. subsidiary) and increase the foreign tax credit of the U.S. subsidiary. Similarly, consider a case where a

¹¹ Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010" (JCX-46-10), August 10, 2010 (the "JCT Report"), at 6.

¹² The Notice lists four examples of "disregarded debt instruments": (i) an obligation between two disregarded entities that are owned by the same Section 902 Corporation; (ii) a debt instrument where both the issuer and the holder are disregarded entities owned by a single partnership with one or more partners that are Section 902 Corporations; (iii) an obligation between a Section 902 Corporation and an entity disregarded from the same Section 902 Corporation; and (iv) a debt instrument between a partnership in which a Section 902 Corporation is a partner and an entity that is disregarded from that partnership.

U.S. parent has a foreign subsidiary (“FS1”) that owns two foreign corporations: FS2 (an entity that is disregarded for U.S. federal income tax purposes from FS1), and FS3 (an entity that is treated as a corporation separate from FS1 for U.S. federal income tax purposes). If FS1 makes a loan to FS2 that generates a loss for FS2 for local income tax purposes—and FS2 surrenders that loss to FS3—the surrender effectively shifts the local income tax liability of FS3 to FS1, which may increase the foreign tax credit available to the U.S. parent on distributions from FS1.

4. Hybrid Instruments

The fourth category of Pre-2011 Splitter Arrangements identified by the Notice involves an instrument that is either: (i) treated as equity under U.S. federal income tax law, but as debt for local non-U.S. tax purposes (a “U.S. Equity HI”) or (ii) treated as debt for U.S. federal income tax purposes, but as equity under local non-U.S. tax law (a “U.S. Debt HI”).

If the issuer of a U.S. Equity HI is a covered person with respect to a Section 902 Corporation that owns a U.S. Equity HI, the Notice provides that there will be a Pre-2011 Splitter Arrangement if Legacy Taxes were paid or accrued by a Section 902 Corporation on an amount of interest that is deductible by the issuer of the U.S. Equity HI as interest under local law, but that does not give rise to income under U.S. federal income tax law.¹³

For example, assume a U.S. corporation owns a controlled foreign corporation (“CFC1”) that owns a second controlled foreign corporation in the same country (“CFC2”), and that CFC2 generates income from an active business and issues a hybrid instrument—a U.S. Equity HI—to CFC1. If the U.S. Equity HI accrues (but does not pay on a current basis) interest, the interest would be taxable to CFC1—and deductible by CFC2—under foreign tax law. As a result, CFC2 would shift its liability for foreign tax to CFC1, but without increasing the earnings and profits of CFC1—or reducing the earnings and profits of CFC2—for U.S. federal income tax purposes until the amount of accrued interest was actually paid by CFC2 to CFC1. In the absence of Section 909 and the Notice, the additional tax paid by CFC1 may be creditable by the U.S. corporation under Section 902.¹⁴

A U.S. Debt HI will similarly give rise to a Pre-2011 Splitter Arrangement if the owner of the U.S. Debt HI is a covered person in respect of a Section 902 Corporation that issues the U.S. Debt HI, and a portion of

¹³ The amount of Suspended Legacy Taxes will equal the difference between: (i) the amount of Legacy Taxes that are paid by the owner Section 902 Corporation and (ii) the amount of Legacy Taxes that would have been paid or accrued had the owner Section 902 corporation not been subject to tax on the income from the U.S. Equity HI under local law. The issuer will also, under such a Pre-2011 Splitter Arrangement, have related income in an amount equal to the amounts that are deductible under local law (determined without regard to the issuer’s earnings and profits).

¹⁴ See JCT Report, at 6.

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the Legacy Taxes paid or accrued by the issuer are in respect of interest on the U.S. Debt HI that is not deductible under local non-U.S. tax law.¹⁵

For example, suppose a foreign corporation (“Holdco”) owns two direct subsidiaries, one in the U.S. (“USSub”) and the other in the same foreign country as Holdco (“XSub”). USSub, in turn, has a subsidiary of its own, CFC, which is profitable and is primarily engaged in activities that earn subpart F income. CFC issues a hybrid security—a U.S. Debt HI—to XSub. Under U.S. federal income tax law, CFC may be treated as paying interest to XSub on the hybrid security, and may be entitled to a deduction for this payment; but, because foreign tax law treats the hybrid security as equity, CFC’s foreign tax liability and USSub’s indirect foreign tax credits in respect of CFC may not be reduced by the arrangement, absent Section 909 and the Notice.

C. OPERATING RULES

1. In General

A Section 902 Corporation will be required to account for Pre-2011 Splitter Arrangements under Section 909 beginning with its first taxable year beginning after December 31, 1996. Annual amounts of Suspended Legacy Taxes and income related to such taxes will be aggregated for each separate Pre-2011 Splitter Arrangement.

The determination of annual and aggregate amounts of Suspended Legacy Taxes and related income for each Pre-2011 Splitter Arrangement must be made for each separate category of income¹⁶ of the Section 902 Corporation, each covered person and any other person that succeeds to the income and Suspended Legacy Taxes of a Pre-2011 Splitter Arrangement. If a Pre-2011 Splitter Arrangement involves a disregarded debt instrument and a shared loss, the amount of the related income in each separate category of the covered person will be equal to the amount of income in that separate category that was offset by the shared loss. If a Pre-2011 Splitter Arrangement involves a U.S. Equity HI, the related income will, under the Notice, be allocated among the issuer’s foreign tax credit limitation baskets in the same manner as the Suspended Legacy Taxes. Earnings and profits (including related income) and foreign income taxes will, under the Notice, be assigned to the relevant baskets using general foreign

¹⁵ In such an arrangement, the amount of Suspended Legacy Taxes will equal the amount of tax that would have been offset by the interest that is paid or accrued had that interest been deductible under the law of the foreign jurisdiction. In addition, the amount of related income will be equal to the gross amount of interest income recognized for U.S. federal income tax purposes by the owner of the U.S. Debt HI (also determined without regard to the amount of the owner’s earnings and profits).

¹⁶ This would include categories from Treasury Regulations Section 1.904-4(m), such as certain income and gain that are re-sourced under a tax treaty, and presumably the traditional baskets of Section 904.

tax credit limitation principles.¹⁷ A Section 902 Shareholder must apply consistent methodologies to determine amounts of Suspended Legacy Taxes and related income.

2. Related Income

The Notice also provides detailed rules for taking into account the income that is related to Suspended Legacy Taxes, which can roughly be broken into: (i) rules for accounting for related income; (ii) rules governing distributions, deemed distributions and other inclusions; and (iii) rules governing when income related to Suspended Legacy Taxes is taken into account.

a. Accounting

Under the Notice, covered persons with respect to Pre-2011 Splitter Arrangements that involve either: (i) a reverse hybrid or (ii) a foreign consolidated group must adjust the amount of related income each year by the net amount of income and expense attributable to their activities that give rise to the related income included in the foreign tax base.

Related income, under the Notice, is determined without regard to Treasury Regulations Section 1.960-1(i)(4) or Section 952(c)(1) (provisions dealing with deficits and limited earnings). The Notice further provides that related income generally carries over in circumstances where earnings and profits are assumed by another corporation.¹⁸

b. Distributions, Deemed Distributions and Other Inclusions

In cases where the earnings and profits of a covered person include amounts attributable to both related income and other income, the Notice provides a general rule that distributions (and other inclusions from earnings and profits) will be treated as made out of related income and other income on a *pro rata* basis. However, taxpayers will be permitted to elect to treat all distributions, deemed distributions and other inclusions from earnings and profits as being made first out of related income.¹⁹ Distributions of related income will retain their character as “related income,” and remain connected to the same Suspended Legacy Taxes, even if distributed through a partnership or other pass-through entity.

c. When Related Income Is Taken into Account

A Section 902 Shareholder will generally be treated as taking into account income related to Suspended Legacy Taxes to the extent the income is included as gross income by either the Section 902 Shareholder or an affiliated corporation with which it files a consolidated U.S. federal income tax return upon a distribution, deemed distribution or other inclusion. A Payor Section 902 Corporation will be

¹⁷ See Treas. Reg. §§ 1.904-4; -5, -7 and -7T (earnings and profits); Treas. Reg. § 1.904-6 (foreign taxes).

¹⁸ See, e.g., Section 381; Treas. Reg. § 1.367(b)-7.

¹⁹ Taxpayers may make this election by using the “related income first” method on a timely filed, original tax return during the first taxable year in which they are subject to these rules.

treated as taking related income into account to the extent either: (i) the related income is reflected in the earnings and profits of the Payor Section 902 Corporation because of a distribution, deemed distribution or inclusion out of the earnings and profits of the covered person attributable to the related income or (ii) the Payor Section 902 Corporation and the covered person are combined in certain nonrecognition transactions.²⁰ However, distributions of previously taxed income will not be treated as distributions of related income.

3. Suspended Legacy Taxes

The Notice also provides preliminary guidance regarding the treatment of Suspended Legacy Taxes. In particular, the IRS and Treasury Department intend to:

- Require Section 902 Corporations that have pools of Legacy Taxes comprising both Suspended Legacy Taxes and other amounts to treat taxes deemed paid as being attributable to Suspended Legacy Taxes and other foreign taxes on a *pro rata* basis;
- Treat Suspended Legacy Taxes paid in Pre-Effective Taxable Years in connection with a dividend paid to an upper-tier foreign corporation (that itself is a Section 902 Corporation) as retaining their character as Suspended Legacy Taxes;²¹
- Provide that Suspended Legacy Taxes will carry over to other corporations (for example, in nonrecognition transactions in which tax attributes are received by an acquiring corporation under Section 381); and
- Treat Suspended Legacy Taxes as being “released” as their related income is taken into account by the Payor Section 902 Corporation or a Section 902 Shareholder. In the case of a Pre-2011 Splitter Arrangement involving a reverse hybrid or a foreign consolidated group, if the aggregate related income is reduced to zero, other than because of a distribution, deemed distribution or certain other inclusions, Suspended Legacy Taxes will remain suspended until the amount of aggregate related income is positive, and the related income is taken into account by the Payor Section 902 Corporation or a Section 902 Shareholder.

4. Partnerships and Trusts

Consistent with Section 909(c)(1), the Notice provides that the operative rules of Section 909 will apply at the partner level, and that foreign taxes that are paid by a partnership will generally be Suspended Legacy Taxes to the extent that: (i) those taxes are allocated to a Section 902 Corporation and (ii) those taxes would otherwise be Suspended Legacy Taxes if they had been paid directly by the Section 902 Corporation. However, Section 909 will not apply to foreign taxes paid or accrued by a partner, even if the partnership is a covered person in respect of the partner, to the extent the related income is taken into account by that partner.

In addition, the Notice indicates that certain allocations that conform with the existing regulations for allocating a partner’s distributive share of income can result in the separation of foreign taxes and related

²⁰ See Section 381(a)(1) and Section 381(a)(2).

²¹ However, after such a distribution, the receiving shareholder would then be treated as the Payor Section 902 Corporation.

income.²² Such allocations will not, in and of themselves, be treated as Pre-2011 Splitter Arrangements, although other features (for example, a payment on a disregarded debt instrument that gives rise to a shared loss) could nonetheless cause a partnership making such conforming allocations to be part of one of the four classes of Pre-2011 Splitter Arrangements described above. Moreover, for Post-Effective Taxable Years, the IRS and Treasury Department intend to apply Section 909 to partnership allocations of interbranch income²³ to the extent that such allocations assign foreign taxes to a partner other than the partner to which they assign than the associated income.

D. INTERACTION OF SECTION 909 WITH OTHER CODE PROVISIONS

1. Carrybacks and Carryforwards

Taxpayers may generally carry excess foreign tax credits back for one year, and forward for up to ten years.²⁴ The Notice indicates that the IRS and Treasury Department intend to issue regulations providing that Section 909 does not apply to Legacy Taxes that are carried forward to a Post-Effective Taxable Year.

2. Year of Accounting for Foreign Taxes

The Notice observes that Section 909 does not change the general principles that determine when a creditable foreign tax has been paid. However, except for the purpose of determining the U.S. dollar amount of foreign taxes that have accrued (and other purposes that Treasury may determine), foreign taxes that are suspended under Section 909 are treated as paid or accrued in the year the related income is taken into account. Accordingly, the Notice provides that the year the related income is taken into account, and not the year to which the tax relates, is the year that determines: (i) when a taxpayer may claim a deduction for a foreign tax;²⁵ (ii) whether a taxpayer may carry a foreign tax credit to another taxable year;²⁶ and (iii) the extended statute of limitations for claiming a foreign tax credit or associated refund.²⁷

3. Redeterminations

Under Section 905(c), taxpayers must generally notify the IRS if an amount of foreign tax: (i) differs when paid from the amount claimed as a credit; (ii) is not paid within two years after the close of the taxable year to which the tax relates; or (iii) is refunded. If an amount of foreign tax that has been claimed as a “direct” credit is redetermined, the taxpayer must generally adjust its U.S. federal income tax liability for

²² See, e.g., Treas. Reg. § 1.704-1(b)(4)(viii)(d) and § 1.704-1(b)(5), ex. 24.

²³ See Treas. Reg. § 1.704-1(b)(4)(vii)(d)(3).

²⁴ See Section 904(c).

²⁵ See Section 164(a).

²⁶ See Section 904(c).

²⁷ See Section 6511(d)(3)(A).

the relevant year. However, in cases where a foreign tax has been claimed as an “indirect” credit, a taxpayer is generally required to adjust its pools of foreign tax credit and undistributed earnings in respect of a redetermined foreign tax, in lieu of adjusting its U.S. federal income tax liability.

Under the Notice, additional amounts of foreign taxes that are claimed as a “direct” credit under Section 901 will not be subject to Section 909 if the foreign tax assessment relates to a Pre-Effective Taxable Year, even if the redetermination occurs in a taxable year to which Section 909 would otherwise apply. However, additional amounts of foreign taxes that are claimed by Section 902 Corporations will generally be treated as Legacy Taxes that are subject to Section 909 and, to the extent they are attributable to Pre-2011 Splitter Arrangements, will be Suspended Legacy Taxes.

E. EFFECTIVE DATE

Although the legislation enacting Section 909 left ambiguity regarding whether Section 909 could apply to foreign taxes that were claimed as an “indirect” credit after December 31, 2010, regardless of when the taxpayer’s first taxable year after December 31, 2010 begins, the Notice indicates that the IRS and Treasury Department intend to issue regulations providing that the effective date of Section 909, for this purpose, is the beginning of the Section 902 Corporation’s first Post-Effective Taxable Year. In addition, the Notice provides that the IRS and Treasury Department intend to issue regulations providing that in cases where a Section 902 Corporation is a partner in a partnership and taxes are included in a Post-Effective Taxable Year of the Section 902 Corporation, those taxes will be subject to Section 909 even if they were paid or accrued in a taxable year of the partnership that began before December 31, 2010.

F. REQUEST FOR COMMENT

As discussed above, the guidance set forth in the Notice is primarily focused on how taxes that have been paid in connection with Pre-2011 Splitter Arrangements will be treated. The IRS and Treasury Department expect to issue further guidance on Section 909 and request comments on the following subjects:

- The extent to which the 2006 Proposed Regulations should be finalized;
- How to modify Treasury Regulations Section 1.704-1(b)(4)(vii)(d) and Treasury Regulations Section 1.704-1(b)(5), example 24, which provide foreign tax credit allocation rules in the partnership context that could result in a splitting of foreign taxes and associated income;
- Whether and to what extent transactions and arrangements other than Pre-2011 Splitter Arrangements should also be treated as “foreign tax credit splitting events” in Post-Effective Taxable Years. In particular, the IRS expressed interest in comments regarding whether the following transactions and arrangements should be treated as “foreign tax credit splitting events”:
 - “Covered asset acquisitions” described in Section 901(m);
 - The incorporation of a disregarded entity or a hybrid partnership with respect to foreign income taxes paid in the year of incorporation, or attributable to a significant timing difference;
 - Transfer pricing adjustments;
 - Group relief structures not otherwise described in the Notice;

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- Sale and repurchase agreements (*i.e.*, “repos”) in both the related and unrelated counterparty contexts;
- Foreign anti-deferral regimes; and
- Foreign consolidated groups in which members have losses.
- Rules for associating foreign income taxes with related income;
- Ordering rules for dividends out of earnings and profits comprising both related income and other income;
- The effect on related income of losses and deficits in earnings; and
- Additional rules for assigning foreign income taxes and related income to separate categories.

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