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International Tax ADVISORY ■

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Final Regulations on Foreign Tax Credit Splitting Largely Mirror Prior Rules

The U.S. Treasury recently released final regulations on foreign tax credit splitting arrangements (the "2015 Regulations"). The final rules, released the same day that the 2012 temporary and proposed regulations were set to expire (February 9, 2015), offer definitional and other clarifications and add useful illustrations. Fortunately, the 2015 Regulations do not introduce huge changes to the prior rules, and the exclusive list of splitter arrangements remains intact for the time being. Unfortunately, the final rules fail to address a number of "mechanical issues" (i.e., issues concerning the tracking of split taxes and related income), which are "still under consideration."

Background

Added to the Code in 2010, Section 909 is one of Congress's more recent efforts to require taxpayers to "match" foreign tax credits and related income. The statute essentially suspends foreign tax credits until the taxpayer takes the related income into account for U.S. tax purposes, preventing the taxpayer from using differences in U.S. and foreign tax laws to "split" taxes and associated income. (The credit suspension rule also applies to Section 902 corporations, foreign corporations that meet the ownership requirements for the deemed-paid credit under Section 902, and their shareholders.) Notice 2010-92, issued shortly after Section 909's enactment, offered preliminary guidance—namely, describing "pre-2011 splitter arrangements," which include reverse hybrid structures, foreign consolidated groups, group relief or loss sharing regimes and hybrid instruments.

In early 2012, the IRS and Treasury issued temporary and proposed regulations (the "2012 Regulations"), expanding upon and modifying the preliminary guidance. For foreign income taxes paid or accrued on or after January 1, 2011, these rules maintained the list of pre-2011 splitter arrangements and added partnership interbranch payment splitter arrangements. The 2012 Regulations modified the rules for foreign taxes paid or accrued on or after January 1, 2012: expanding the definitions of the hybrid instrument and loss-sharing splitter arrangements and, for tax years beginning after February 14, 2012, removing consolidated group splitter arrangements from the list (due to changes under Section 901 regarding the application of the legal liability rule to combined income regimes effective after that date). The 2012 Regulations also provided mechanical rules for tracking split taxes and related income and deleted a special rule for partnership interbranch payments under Section 704 regulations.

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Reverse Hybrid Splitter Arrangements

As under the 2012 Regulations, a reverse hybrid splitter arrangement occurs when an owner of a reverse hybrid (an entity treated as a corporation for U.S. tax purposes but as fiscally transparent under foreign law) is treated by foreign law as paying or accruing foreign income taxes (i.e., split taxes) on the income of the reverse hybrid. The related income is the earnings and profits (E&P) of the reverse hybrid that were taxable to the owner (under foreign law). The foreign income taxes paid by the owner are split from the related income, which is taxed to the reverse hybrid under U.S. law. Unless and until the owner includes the related income (e.g., receives a distribution from the reverse hybrid), the owner cannot claim a credit for the foreign income taxes.

The 2015 Regulations address concerns regarding the amount of related income in cases where the E&P of the reverse hybrid fluctuates due to subsequent losses. Specifically, Section 1.909-2(b)(1)(v) includes two examples, illustrating how to compute related income for split taxes when a reverse hybrid has income in one year and no income (or a loss) in the following year.

Loss-Sharing Splitter Arrangements

A loss-sharing splitter arrangement exists when and to the extent that the "usable shared loss" of an individual or corporation and all the entities with which it combines income and expense under U.S. tax law (a "U.S. combined income group") is used to offset foreign taxable income of another U.S. combined income group. A usable shared loss is a shared loss of a U.S. combined income group that may offset the group's own income under foreign law.

To illustrate, say U.S. Parent wholly owns CFC1, which in turn wholly owns CFC2, which owns a disregarded entity (DE). CFC1 itself constitutes one U.S. combined income group, and CFC2 and DE constitute a second group. Under foreign tax law, the losses of CFC1 may be used to offset income of CFC2, and vice versa. DE incurs a $100 loss. DE's loss could offset $50 of CFC2 income but instead is used to offset $100 of CFC1 income. The usable shared loss is $50, the amount of CFC2 income that could have been offset by the DE loss. The foreign income taxes paid by CFC2 because it does not use DE's loss are split taxes because, under U.S. law, CFC2 is considered to take DE's loss into account. The related income is $50 of CFC1 income, the amount of CFC1 income offset by the usable shared loss. Until the related income is taken into account by U.S. Parent or CFC2, the payor of the split taxes, U.S. Parent cannot claim a credit for those taxes.

Some commenters asked that the definition of usable shared loss be revised to exclude shared losses that could not be used by a U.S. combined income group in a current foreign tax year but that could be carried forward or backward to a different foreign tax year. The IRS and Treasury agreed to exclude shared loss carryforwards from the definition because of the uncertainty that future foreign taxable income could absorb the losses. Shared losses that can be carried to prior years, however, constitute loss-sharing splitter arrangements under the 2015 Regulations. Taxpayers should note that this "clarification" in the final rules means that foreign income taxes paid or accrued in prior years may become split taxes on a "retroactive basis."

U.S. Equity Hybrid Instrument Splitter Arrangement

A U.S. equity hybrid instrument is an instrument treated as equity for U.S. tax purposes but as debt for foreign tax purposes. The 2012 Regulations provide that a U.S. equity hybrid instrument splitter arrangement arises if payments or accruals with respect to the hybrid instrument (1) give rise to the payment or accrual of foreign taxes by the instrument's owner, (2) are deductible by the issuer under the laws of its foreign jurisdiction, and (3) do not give rise

to income for U.S. tax purposes. The owner does not include income for U.S. purposes and thus cannot claim a credit for the foreign taxes. The question arose whether, under this definition, a splitting event occurs if an accrual for foreign law with respect to the instrument does not give rise to income under U.S. law but payment on the accrual does.

The final rules clarify that a U.S. equity hybrid instrument splitter arrangement exists—regardless whether payment is made on the instrument—if an accrual under foreign law with respect to the instrument (1) provides a foreign-law deduction for the issuer and (2) results in the imposition of foreign income tax on the owner (3) without giving rise to income under U.S. law. Actual payment of an accrued amount may be treated as a distribution of related income, but does not preclude a hybrid instrument from being a splitter arrangement. The 2015 Regulations illustrate this rule with an example. Significantly, the IRS and Treasury declined to extend the hybrid instrument splitter rules to transactions between unrelated persons.

Mechanical Rules to Track Split Taxes and Related Income

The preamble to the new regulations acknowledges "mechanical issues" for tracking related income and to split taxes that the 2012 Regulations do not fully answer. However, the IRS and Treasury have punted, for now, on more comprehensive guidance for the technical aspects of the splitter rules. The 2015 Regulations do clarify that a Section 381 transaction, in which a payor of split taxes combines with the covered person with the related income, will not unsuspend the split taxes unless the transaction causes the payor to take into account the E&P of the covered person equal to the pertinent related income. The preamble notes that the Section 1.909-6T(e)(3) provision disallowing split taxes as a carryover attribute for inbound Section 381 transactions remains—noting that permanent suspension of credits could be avoided by, say, causing distributions to be made to the domestic person prior to the Section 381 transaction.

Effective Dates

The 2015 Regulations are generally effective for tax years ending after February 9, 2015. One exception is that taxpayers can apply Section 1.909-2T to foreign income taxes paid or accrued in their first tax year ending after the general effective date, a potentially helpful option for some taxpayers.

For more information, contact **Edward Tanenbaum** at (212) 210-9425 or **Heather Ripley** at (212) 210-9549.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

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WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, CA 94303-2282 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333