US Outbound Tax Newsalert

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IRS releases final and temporary regulations under sections 901, 909 and 704(b), addressing technical taxpayer rules and tax splitting events

Introduction

In a rare instance of coordinated tax guidance involving multiple Code sections - section 901, 909 and 704(b) - on February 9, 2012, the Treasury Department and IRS issued final and temporary regulations providing guidance on "technical taxpayer" rules and "splitting events." The "technical taxpayer" regulations under sections 901 and 704(b) provide rules relating to the determination of who is considered to have paid a foreign income tax for purposes of the foreign tax credit ("FTC"). The final and temporary regulations under sections 909 and 704(b) address the availability of FTCs when there is a "splitting event" in which foreign income taxes have been separated from the related income.

Technical taxpayer rules

2006 Proposed Regulations

On August 3, 2006, the Treasury Department and IRS issued Prop. Treas. Reg. § 1.901-2(f) to revise the "legal liability" or "technical taxpayer" rule. The proposed regulations provided that, generally, the person with legal liability for a foreign tax on income is "the person who is required to take the income into account for foreign

income tax purposes." Prop. Treas. Reg. 1.901-2(f)(1). The regulations also contained a combined income rule and applied that combined income rule to reverse hybrids.

The 2006 proposed regulations were aimed specifically at FTC planning using (1) foreign consolidated groups, or (2) hybrid or reverse hybrid entities. The proposed regulations may have been issued in response to the taxpayer victory in the *Guardian Industries* case.[1]

2012 Final Regulations

In the 2012 final regulations, the Treasury Department and IRS finalized portions of the 2006 proposed regulations with minor modifications, mainly dealing with the allocation of foreign taxes among members of a foreign consolidated group. The final regulations are generally effective for foreign taxes paid or accrued in tax years beginning after February 14, 2012. The final regulations also permit taxpayers to apply the combined income rules of the final regulations to taxable years beginning after December 31, 2010 and on or before February 14, 2012.

Definition of "legal liability"

The definition of "legal liability" included under the 2006 proposed regulations was not finalized. Prop. Treas. Reg. § 1.901-2(f)(1)(i) had stated: "… foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes…" The IRS and Treasury stated in the preamble to the final regulations (T.D. 9576) that they were considering to what extent to clarify this general rule, for example, whether there should be a special rule for determining who has legal liability in the case of certain "repo" transactions. In addition, the final regulations provide that US tax principles apply to determine the tax consequences if one person remits a tax that is the legal liability of another person.

Partnership terminations and transfers

The final regulations add rules providing for the apportionment of foreign taxes when a partnership terminates (either actually or a technical termination under section 708(b)(1)(B)) and also add rules to apportion taxes when a partner's interest in a partnership changes under the "varying interests" rule of Treas. Reg. § 1.706-1(c)(4). Rules are also provided for cases where a partnership becomes a disregarded entity (by having only one member) or when a disregarded entity becomes a partnership (when a disregarded entity adds a second member). Under all of these scenarios, the final regulations apportion the foreign taxes on a pro rata basis based on the period of time in each segment under the principles of Treas. Reg. § 1.1502-76.

Foreign combined groups

With respect to foreign combined groups, foreign tax is considered imposed on the combined income of two or more persons if such persons compute their taxable income on a "combined basis" under foreign law. Tax is considered to be computed on a "combined basis" if two or more persons that would otherwise be subject to foreign tax on their separate taxable incomes add their items of income, gain,

[1] *Guardian Industries Corp. and Subs. v. U.S.*, 477 F.3d 1368 (Fed. Cir. 2007).

deduction and loss to compute a single consolidated taxable income amount for foreign tax purposes.

Foreign tax is not considered to be imposed on the combined income of two or more persons if, because one or more of such persons is a fiscally transparent entity under foreign law, only one of such persons is subject to tax under foreign law. In addition, foreign tax is not considered imposed on combined income solely because foreign law:

1. Permits one person to surrender a loss to another person pursuant to a group relief or other ***loss-sharing regime***;
2. Requires a shareholder of a corporation to include in income amounts attributable to taxes imposed on the corporation with respect to distributed earnings, pursuant to an ***integrated tax system*** that allows the shareholder a credit for such taxes;
3. Requires a shareholder to include, pursuant to an ***anti-deferral regime***, income attributable to the shareholder's interest in the corporation;
4. Reallocates income from one person to a related person under ***foreign transfer pricing*** provisions;
5. Requires a person to take into account a ***distributive share*** of taxable income of an entity that is a partnership or other fiscally transparent entity for foreign tax purposes; OR
6. Requires a person to take all or part of the income of an entity that is a corporation for US tax purposes into account because foreign law treats the entity as a branch or fiscally transparent entity (a ***reverse hybrid***). A reverse hybrid does not include an entity that is treated under foreign law as a branch or fiscally transparent entity solely for purposes of calculating combined income of a foreign consolidated group.

Foreign tax must be apportioned among the persons whose income is included in the combined base pro rata based on each person's portion of the combined income, as computed under foreign law, without regard to whether the group members are jointly and severally liable for the tax under foreign law. Combined income with respect to each foreign tax that is imposed on a combined basis, and combined income subject to tax exemption or preferential tax rates, is computed separately, and the tax on that combined income base is allocated separately.

Intercompany payments that are deductible under foreign law will affect the determination of separate taxable income of combined group members, even if such payments are not deductible (or are disregarded) for purposes of US tax law.

Figure 1 below (Temp. Treas. Reg. § 1.901-2(f)(5), Example 1) illustrates how income is separately calculated for members of a foreign combined group for purposes of allocating foreign tax under the technical taxpayer rules.

Figure 1

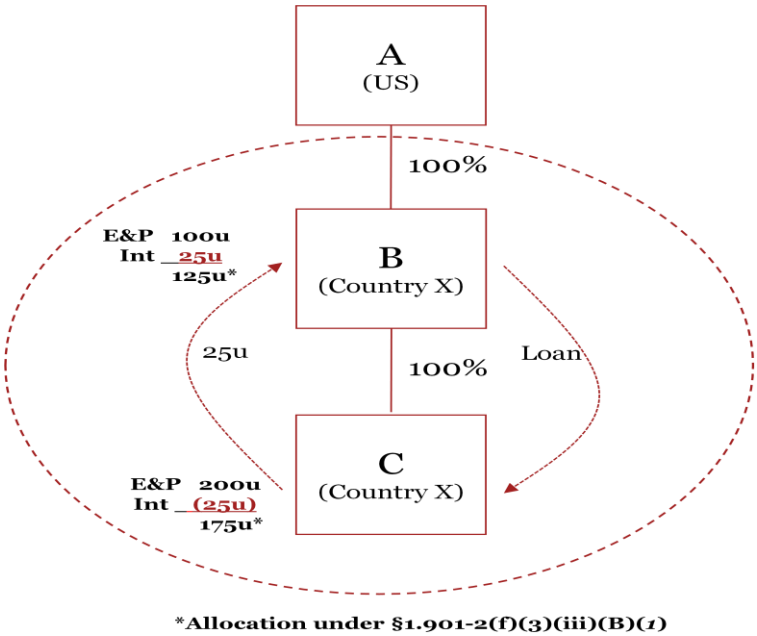
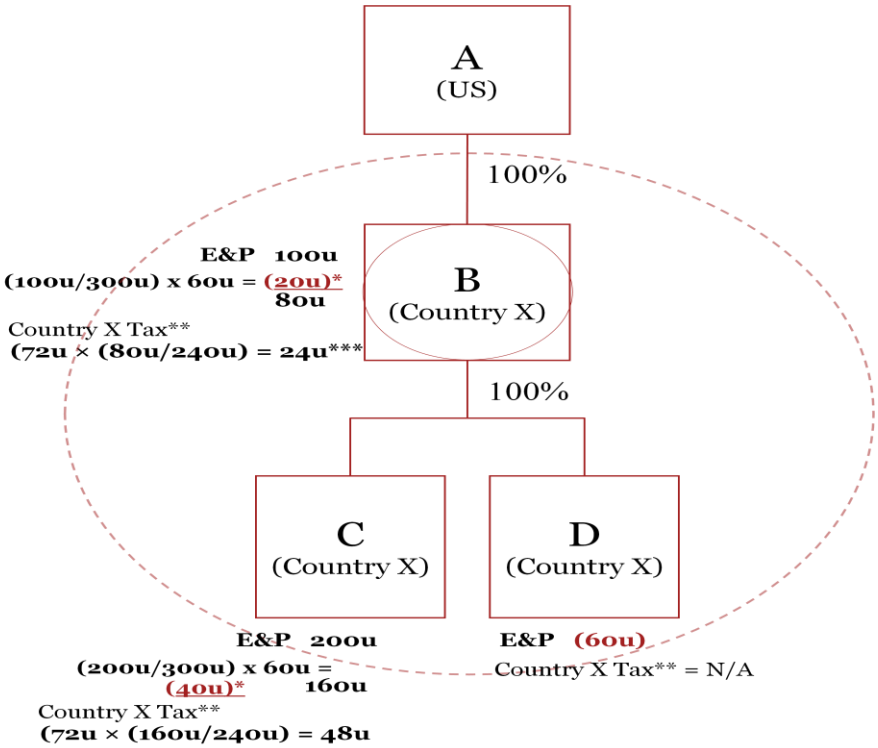


Figure 2 below (Temp. Treas. Reg. § 1.901-2(f)(5), Example 2) illustrates how losses are apportioned among members of a foreign combined group for purposes of allocating foreign tax under the technical taxpayer rules.

Figure 2



Coordination with section 909

Before finalization of the technical taxpayer regulations, section 909 would have applied to consolidated groups (defined as situations in which foreign tax is imposed on combined income), where the consolidated taxes were not allocated appropriately among the members of the group and resulted in the separation of foreign income tax from the related income. Section 909 may still apply to foreign taxes paid or accrued on combined income during tax years beginning after December 31, 2010, and on or before February 14, 2012 when a taxpayer does not allocate the foreign consolidated tax liability among the members of the foreign consolidated group based on each member's share of the consolidated taxable income, under the principles of former Treas. Reg. §1.901-2(f)(3).

The table below illustrates the effective dates relevant to the application of section 901 and 909 to foreign combined groups:

Foreign combined groups		
	How taxes are allocated to CFCs	**Is sec. 909 applicable?**
Tax years beginning on or before 12/31/10	Joint & several liability technical taxpayer rule, Notice 2010-92 regarding application of section 909 to foreign taxes paid or accrued in post-1996 years	No, except for taxes not taken into account by a US shareholder prior to 1/1/11
Tax years beginning on or after 1/1/11 and on or before 2/14/12	Sec. 909 applicable, unless principles of previous section 901 final regulations applied	Yes
Tax years beginning after 2/14/12	Sec. 901 "push down of taxes" method applicable	No

Regarding the foreign income tax of reverse hybrids, the Treasury Department and the IRS stated that they will not finalize the portion of the 2006 proposed regulations relating to the determination of the person who paid a foreign income tax with respect to such income. Notice 2010-92 identifies reverse hybrids as pre-2011 splitter arrangements. Section 909 temporary regulations also identify reverse hybrids as splitter arrangements.

Section 909 Temporary Regulations

Section 909 statutory law

Section 909 was enacted in August 2010. The provision targeted certain situations in which FTCs are claimed under sections 901 or 902 for foreign taxes paid on income that has not yet been subjected to US federal income tax.

Section 909 provides that if there is an FTC splitting event with respect to a foreign income tax paid or accrued by a taxpayer, that tax shall not be taken into account for US federal income tax purposes before the tax year in which the related income is taken into account by the taxpayer.

Section 909 goes on to provide special rules for "section 902 corporations," which are defined as foreign corporations with respect to which one or more domestic corporations meets the ownership requirements of section 902(a) or (b) (a "section 902 shareholder").

If there is an FTC splitting event with respect to a foreign income tax paid or accrued by a section 902 corporation, the tax will not be taken into account for purposes of section 902 or 960, or for determining earnings and profits ("E&P") under section 964(a), before the tax year in which the related income is taken into account by the section 902 corporation or a section 902 shareholder. Thus, under section 909(b), the tax is not added to the section 902 corporation's pool of "post-1986 foreign income taxes," and its pool of "post-1986 undistributed earnings" is not reduced by that tax. In the case of a partnership, section 909 applies at the partner level.

There is an FTC splitting event under the statute with respect to a foreign income tax if the related income is (or will be) taken into account by a "covered person," which section 909 defines as (1) any entity in which the payor of the tax holds, directly or indirectly, at least a 10 percent ownership interest (by vote or value); (2) any person that holds, directly or indirectly, at least a 10 percent ownership interest (by vote or value) in the payor; (3) any person that has a section 267(b) or 707(b) relationship to the payor; and (4) any other person identified by the IRS.

The statutory language of section 909 does not apply to timing differences where the same person pays the tax but takes into account the related income in a different tax period. In general, any foreign income tax not currently taken into account by reason of section 909 is taken into account as a foreign income tax paid or accrued when, and to the extent that, the taxpayer, the section 902 corporation or a section 902 shareholder takes the related income into account.

Notice 2010-92

In Notice 2010-92, the IRS provided initial guidance concerning section 909 on FTC splitting events. This Notice primarily addressed the application of section 909 to foreign income taxes paid or accrued by a section 902 corporation in tax years beginning on or before December 31, 2010. In the new temporary section 909 regulations, Notice 2010-92 has been incorporated as Temp. Treas. Reg. §1.909-6T.

Notice 2010-92 provided detailed guidance, focused on rules for determining whether pre-2011 taxes are suspended under section 909 in post-2010 tax years of a section 902 corporation. The Notice identified an exclusive list of arrangements treated as giving rise to FTC splitting events in pre-2011 tax years ("pre-2011 splitter arrangements") and provided guidance on determining the amount of related income and pre-2011 taxes paid or accrued with respect to pre-2011 splitter arrangements.

The specific pre-2011 splitter arrangements identified were:

- *Certain reverse hybrid structures*: Where taxes were paid or accrued by a section 902 corporation with respect to income of a reverse hybrid entity in which it held a 10% interest (or the reverse hybrid was otherwise a "covered person," for that section 902 corporation).

- *Certain foreign consolidated groups*: Where the taxpayer did not allocate a foreign consolidated tax liability among the members of a foreign consolidated group based on each member's share of the consolidated taxable income included in the foreign tax base under the principles of former Treas. Reg. §1.901-2(f)(3).
- *Certain group relief and other loss-sharing regimes*: Where (i) there was an instrument that was treated as debt under the laws of the jurisdiction in which the issuer was subject to tax but which was disregarded for US federal income tax purposes (a "disregarded debt instrument"), (ii) the owner of the disregarded debt instrument paid a foreign income tax attributable to a payment or accrual on the instrument, (iii) the payment or accrual on the disregarded debt instrument gave rise to a deduction for foreign tax purposes, and (iv) the issuer of the disregarded debt instrument incurred a shared loss that was taken into account under foreign law by one or more other entities that were covered persons with respect to the owner of the instrument.
- *Certain hybrid instruments*: Where a financial instrument was treated either (1) as equity for US federal income tax purposes but as debt for foreign tax purposes or (2) as debt for US federal income tax purposes but as equity for foreign tax purposes, there could be a splitter arrangement under certain circumstances if the issuer was a covered person with respect to a section 902 corporation that was the owner of the instrument.

In addition to the exclusive list of FTC splitter arrangements from pre-2011 tax years that could generate split taxes subject to section 909 suspension for post-2010 tax years, Notice 2010-92 identified certain pre-2011 taxes that are not subject to section 909 suspension for post-2010 tax years:

- Pre-2011 split taxes paid or accrued by a section 902 corporation in its tax years beginning before January 1, 1997.
- Pre-2011 taxes not paid or accrued in connection with a pre-2011 splitter arrangement (as defined above).
- Pre-2011 taxes paid or accrued in connection with a pre-2011 splitter arrangement ("pre-2011 split taxes") that were deemed paid under section 902(a) or 960 on or before the last day of the section 902 corporation's last pre-2011 tax year.
- Pre-2011 split taxes for which (1) the payor section 902 corporation took the related income into account in a pre-2011 tax year or (2) a US shareholder of a section 902 corporation took the related income into account by the end of the section 902 corporation's last pre-2011 tax year.

Notice 2010-92 also addressed the application of section 909 to partnerships and trusts, as well as the interaction between section 909 and other parts of US federal income tax law, notably the section 704(b) regulations on a partnership's allocation of foreign taxes.

The new section 909 Temporary Regulations

In general

As noted above, the new section 909 temporary regulations incorporate Notice 2010-92, and they do not depart fundamentally from the approach taken in the Notice. However, they do add a new category of FTC splitting events arising from partnership inter-branch payments, they eliminate the consolidated group's splitter category for years, and they make some significant changes in the scope of certain other

categories. In addition, they provide a confusing patchwork of effective dates and transition rules that vary from category to category, which will call for a high level of awareness on the part of companies that may have splitter arrangements under the new definitions.

In general, Temp. Treas. Reg. §1.909-1T provides definitions and general rules. It includes rules substantially similar to those set forth in Notice 2010-92 concerning the application of section 909 to partnerships and trusts, except that the temporary regulations expand the scope of the rules to include S corporations and taxes paid or accrued by persons other than section 902 corporations. Generally, section 909 applies at the partner level, and similar rules apply in the case of an S corporation or trust. The temporary regulations adopt an aggregate approach. Accordingly, for purposes of determining whether related income is taken into account by a covered person, related income of a partnership, S corporation or trust is considered to be taken into account by the partner, shareholder or beneficiary to whom the related income is allocated.

The temporary regulations depart from Notice 2010-92 in applying section 909 to situations where related income was taken into account by a covered person before the associated foreign income tax is paid or accrued (for example, due to a timing difference).

The rules governing when split taxes and related income are taken into account are substantially similar to those in Notice 2010-92. However, Temp. Treas. Reg. §1.909-3T(b) adds a new rule with respect to foreign taxes paid or accrued in years beginning on or after January 1, 2011, with respect to a disregarded payment. Specifically, the rule provides that split taxes include taxes from that period with respect to the amount of a disregarded payment that is deductible by the payor in the foreign country where the payor is taxed on the related income from a splitter arrangement. The amount of the deductible disregarded payment to which this rule applies is limited to the amount of related income from the splitter arrangement. This rule could apply, for example, where a CFC owns a disregarded entity that makes a payment to a sister disregarded entity.

Observation: This new retroactive rule governing disregarded payments could be a trap for the unwary.

The mechanics of applying section 909 to split taxes and related income

The temporary regulations follow Notice 2010-92, creating new pools for section 902 corporations of post-1996 income and of suspended foreign taxes, maintained annually. Distributions (actual or deemed) of E&P must be divided pro rata between related income and other income. Although Notice 2010-92 allowed taxpayers to choose to apply a favorable LIFO-type approach (in which the distributions were treated as coming first out of related income) for pre-2011 years, that rule has not been extended to post-2010 tax years.

The determination of (i) related income, (ii) other income, (iii) split taxes, and (iv) other taxes, and the portion of these amounts that were distributed, deemed paid or otherwise transferred or eliminated must be made on an annual basis beginning with the first tax year of the section 902 corporation beginning after December 31, 1996 in which the section 902 corporation paid or accrued a tax with respect to a splitter arrangement. Annual amounts of related income and split taxes are aggregated for each separate splitter arrangement.

The determination of annual and aggregate amounts of related income and split taxes for each splitter arrangement must be made for each section 904(d) basket of the section 902 corporation, each covered person, and any other person that succeeds to the related income and split taxes. There is a consistency requirement for methodologies used by a section 902 shareholder for determining split taxes and related income with respect to all splitter arrangements.

Related income retains that character for the associated split taxes even if it is distributed to persons other than the payor section 902 corporation, and it carries over to other corporations in the same manner as E&P under section 381 or similar rules.

In order to reduce a pool of suspended split taxes and claim FTCs for them, a section 902 shareholder or section 902 corporation must take related income into account. Related income will be considered taken into account:

1. By a section 902 shareholder to the extent that the related income is recognized as gross income by the section 902 shareholder or a member of its consolidated group affiliate from a distribution, deemed distribution, or inclusion out of the covered person's E&P attributable to the related income.

2. By a payor section 902 corporation if (a) the related income is reflected in the corporation's E&P for US federal income tax purposes through a distribution, deemed distribution, or inclusion out of a covered person's E&P attributable to the related income, or (b) the payor section 902 corporation and the covered person are combined in a section 381(a)(1) or (2) transaction.

The rules for the treatment of split taxes follow principles similar to the rules for related income discussed above.

- Foreign taxes deemed paid under section 902 or 960 (or otherwise removed from post-1986 foreign income taxes) will be treated as attributable to split taxes and other taxes on a pro rata basis.
- Split taxes deemed paid for a dividend paid to a section 902(b) shareholder retain their character as split taxes, and the section 902(b) shareholder will be treated as the payor section 902 corporation.
- Split taxes that carry over to another foreign corporation retain their character as split taxes, and the transferee foreign corporation will be treated as the payor section 902 corporation.
- For each splitter arrangement, as related income is taken into account by the payor section 902 corporation or a section 902 shareholder, a ratable portion of the associated split taxes will no longer be treated as split taxes.

Effective dates and transition rules

As mentioned above, the effective dates and transition rules for the application of the temporary section 909 regulations are somewhat complex and potentially confusing.

The following is a brief summary:

- The general rules of Temp. Treas. Reg. §1.909-1T apply to taxable years beginning on or after January 1, 2011.
- Foreign taxes paid or accrued by any person in a tax year beginning on or after 1/1/11 and before 1/1/12, in connection with a pre-2011 splitter arrangement, are split taxes to the same extent that such taxes would have

been treated as pre-2011 split taxes if such taxes were paid or accrued by a section 902 corporation in a pre-2011 tax year.

- The temporary regulations provide an exclusive list of splitter arrangements for foreign taxes paid or accrued in tax years beginning on or after 1/1/11 and before 1/1/12.
- The temporary regulations provide an exclusive list of splitter arrangements for foreign taxes paid or accrued in tax years beginning on or after 1/1/12.
- The temporary regulations treat the foreign consolidated group splitter arrangement described in Temp. Treas. Reg. §1.909-6T(b)(2) as creating a splitter with respect to foreign tax paid or accrued in a tax year beginning on or after 1/1/11 and on or before 2/14/12.
  - Foreign tax paid or accrued by any person in a tax year beginning on or after 1/1/12 and on or before 2/14/12 in connection with a foreign consolidated group splitter arrangement described in Temp. Treas. Reg. §1.909-6T(b)(2) are split taxes to the same extent that such taxes would have been treated as pre-2011 split taxes if such taxes were paid or accrued by a section 902 corporation in a pre-2011 year.
- Foreign corporations that become section 902 corporations must account for split taxes paid or accrued and related income in pre-acquisition tax years beginning on or after 1/1/12.
- Regarding coordination rules for related income and split taxes, rules similar to those in Notice 2010-92, §4.06 will continue to apply in tax years beginning on or after 1/1/11 until further guidance is issued.
  - However, the alternative "related income first" method for identifying distributions of related income will apply only to identify the amount of pre-2011 split taxes of a section 902 corporation that are suspended as of the first day of the first tax year beginning after 1/1/11.
- The new section 704 temporary regulations provide a transition rule for partnerships whose agreements were entered into prior to 2/14/12. If there is no material modification to the agreement on or after 2/14/12, then the partnership may apply the provisions of Treas. Reg. §1.704-1(b)(4)(viii)(*c*)(*3*)(*ii*) and 1.704-1(b)(4)(viii)(*d*)(*3*) as in effect prior to 2/14/12.

The following matrix summarizes where to find definitions for particular types of splitter arrangement during particular periods specified by the temporary section 909 regulations:

Periods in which taxes paid	Tax years starting before 1/1/11	Tax years starting 1/1/11 - 12/31/11	Tax years starting 1/1/12 - 2/14/12	Tax years starting 2/15/12 or later
Definition of splitter types				
Reverse hybrids	Not. 2010-92 (Treas. Reg. §1.909-6T)	Not. 2010-92 (Treas. Reg. §1.909-6T)	Treas. Reg. §1.909-2T(b)(1)	Treas. Reg. §1.909-2T(b)(1)
Foreign consolidated groups	Not. 2010-92 (Treas. Reg. §1.909-6T), UNLESS the principles of former Treas. Reg. §1.901-2(f)(3) have been applied	Not. 2010-92 (Treas. Reg. §1.909-6T) UNLESS the principles of former Treas. Reg. §1.901-2(f)(3) have been applied	Not. 2010-92 (Treas. Reg. §1.909-6T) UNLESS the principles of former Treas. Reg. §1.901-2(f)(3) have been applied	Treas. Reg. §1.901-2(f)(3)
Hybrid instruments	Not. 2010-92 (Treas. Reg. §1.909-6T)	Not. 2010-92 (Treas. Reg. §1.909-6T)	Treas. Reg. §1.909-2T(b)(3)	Treas. Reg. §1.909-2T(b)(3)
Loss-sharing (group relief)	Not. 2010-92 (Treas. Reg. §1.909-6T)	Not. 2010-92 (Treas. Reg. §1.909-6T)	Treas. Reg. §1.909-2T(b)(2)	Treas. Reg. §1.909-2T(b)(2)
Partnership inter-branch payments	N/A	Treas. Reg. §1.909-2T(b)(4)	Treas. Reg. §1.909-2T(b)(4)	Treas. Reg. §1.909-2T(b)(4)

Types of splitter arrangements in the Temporary Regulations

1. *Reverse hybrid structures*

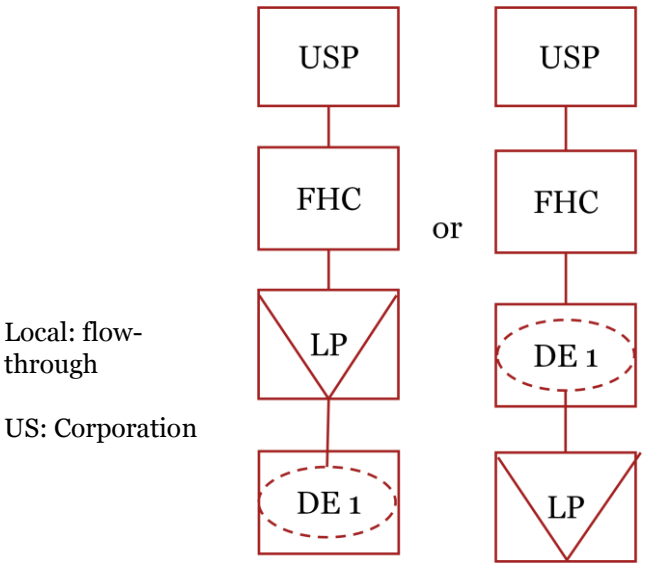
Under Treas. Reg. § 1.909-2T(b)(1), as in Notice 2010-92, a reverse hybrid structure exists when the owner of a reverse hybrid is subject to tax on the income of that entity under foreign law. The related income for section 909 purposes is the E&P of the reverse hybrid attributable to the activities giving rise to income included in the foreign tax base.

The related income of the reverse hybrid would not include any item of income or expense attributable to a disregarded entity owned by the reverse hybrid if income attributable to the activities of the disregarded entity is not included in the foreign tax

base. The only change in the section 909 regulations is a scope expansion to cover taxes paid or accrued by persons other than section 902 corporations.

See Figure 3 below for examples of reverse hybrid structures.

Figure 3



***Observation*:** The IRS has targeted reverse hybrid arrangements for some time. Because Notice 2010-92 essentially addressed all of the existing concerns about FTC splitting events involving reverse hybrids, there has been no expansion of the scope of this category except with respect to the general expansion of payors beyond simply section 902 corporations. In the case of reverse hybrids in the corporate chains of US multinationals, this expansion is unlikely to make a significant difference.

2. *Group relief and other loss-sharing regimes*

Temp. Treas. Reg. §1.909-2T(b)(2) expands the types of loss-sharing arrangements that Notice 2010-92 treats as splitter arrangements. For this purpose, a foreign group relief or other loss-sharing regime exists when one US combined income group with a loss permits the loss to offset the income of one or more other combined income groups (a "shared loss"). Notice 2010-92 applied only to shared losses attributable to debt that is disregarded for US federal income tax purposes. Under Temp. Treas. Reg. §1.909-2T(b)(2)(i), however, a "loss-sharing splitter arrangement" exists to the extent a shared loss of a "US combined income group" could have been used to offset income of that group (a "usable shared loss") but is used instead to offset income of another US combined income group. This treatment only applies if the surrendering group could have used the loss in the year of the surrender.

Temp. Treas. Reg. §1.909-2T(b)(2)(ii) defines a US combined income group as a single individual or corporation and all other entities (including entities that are fiscally transparent for US federal income tax purposes) that for US federal income tax purposes combine any of their respective items of income, deduction, gain or loss with the income, deduction, gain or loss of such individual or corporation. Thus, a US combined income group may arise as a result of an entity being disregarded for US federal income tax purposes or, in the case of a partnership and a partner, as a result of the allocation of any item of the partnership to the partner. For this purpose, a

branch is treated as an entity, all members of a US consolidated group are treated as a single corporation, and individuals filing a joint return are treated as a single individual. A US combined income group cannot include more than one individual or corporation.

Under Temp. Treas. Reg. §1.909-2T(b)(2)(iii), the income of a US combined group consists of the aggregate amount of taxable income of the members of the group that have positive taxable income, as computed under foreign law. The amount of shared loss of a US combined income group is the sum of the shared losses of all members of the group. Where a foreign entity is a member of more than one US combined income group, the rules for allocation of foreign income and shared loss among the groups follow foreign law if the entity is fiscally transparent under foreign law, and follows US federal income tax principles if it is not. If the entity is a hybrid partnership with two partners that are in different US combined income groups, income or a shared loss of the hybrid partnership is allocated among the US combined income groups based on how the hybrid partnership allocated the income or loss under section 704(b). There are also additional rules for situations where the income or shared loss would be recognized in another year, or in no year at all.

Temp. Treas. Reg. §1.909-2T(b)(2) further provides that split taxes from a loss-sharing splitter arrangement are foreign income taxes paid or accrued by a member of a US combined income group with respect to income equal to the amount of the usable shared loss of that US combined income group that offsets income of a different US combined income group. The related income of that US combined group is equal to the amount of income of that US combined income group that is offset by the usable shared loss of another US combined income group.

Figure 4 below illustrates the definition of US combined income groups for purposes of section 909 treatment of loss-sharing splitter arrangements.

Figure 4

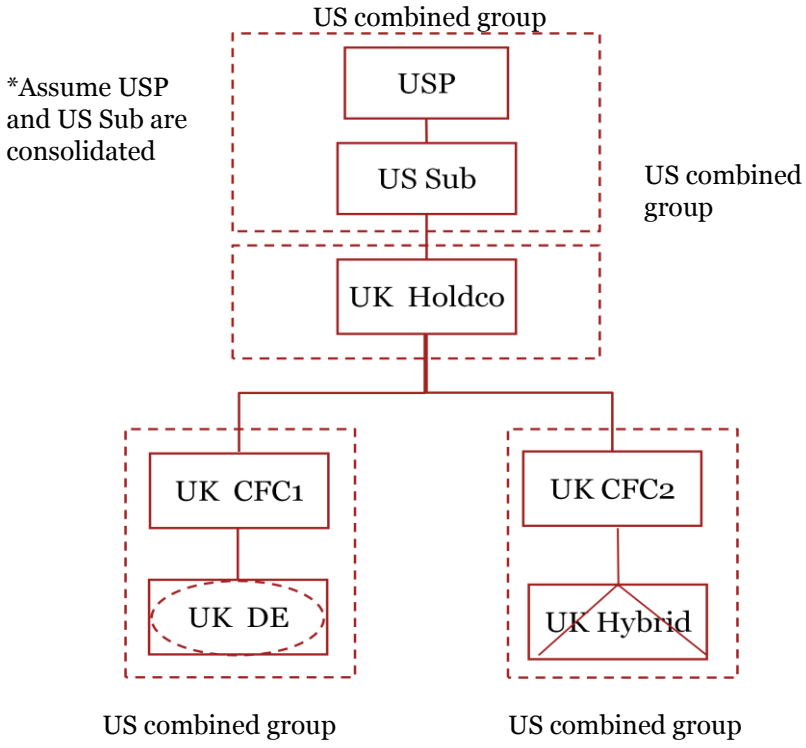


Figure 5 below illustrates the "same-year" rule.

Figure 5

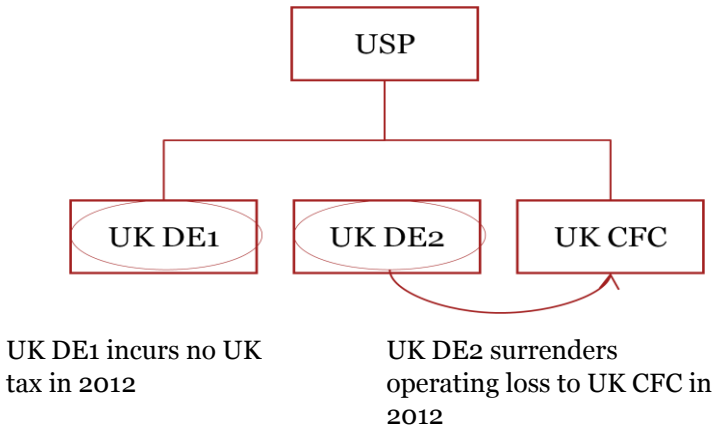


Figure 6 below illustrates a loss-sharing splitter arrangement that would have also have been subject to section 909 under Notice 2010-92.

Figure 6

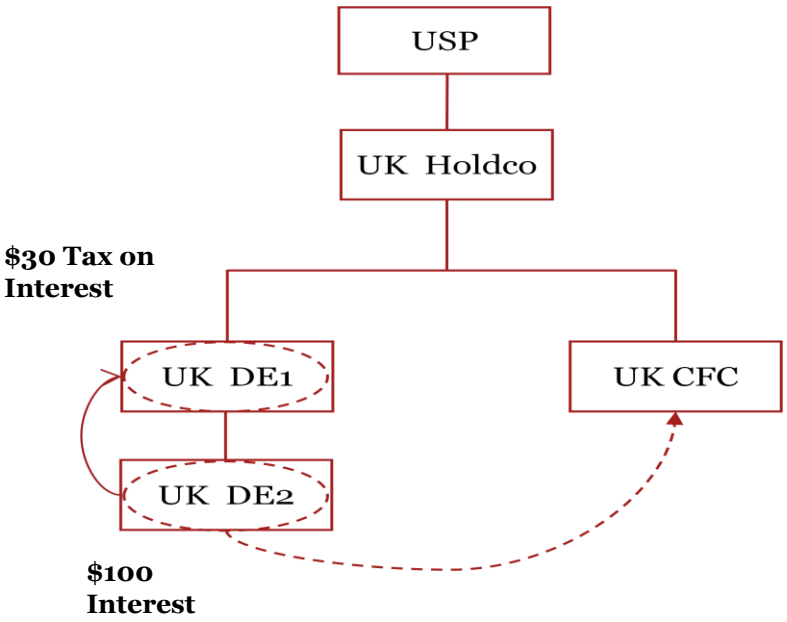
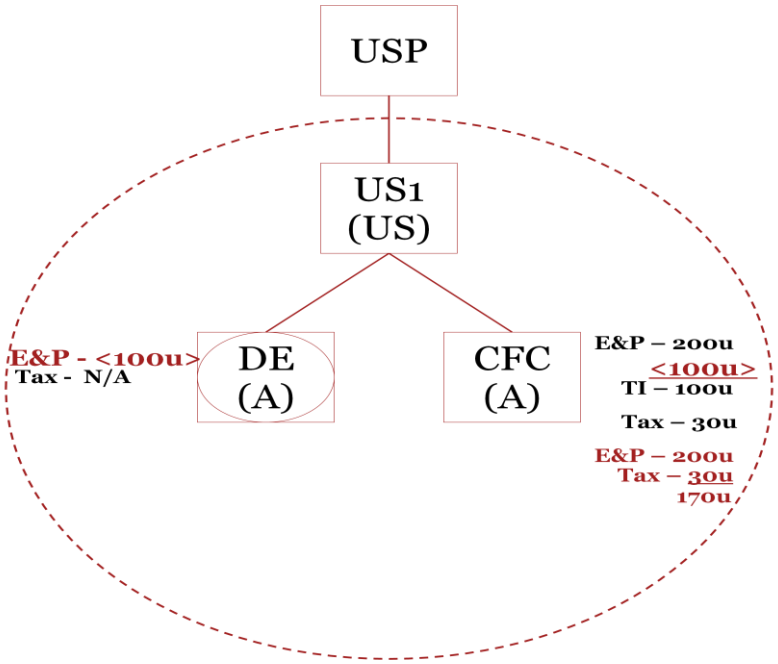


Figure 7 below (Temp. Treas. Reg. §1.909-2T(b)(2)(vii), Example 1) is an example from the regulations illustrating a simple loss-sharing splitter arrangement.

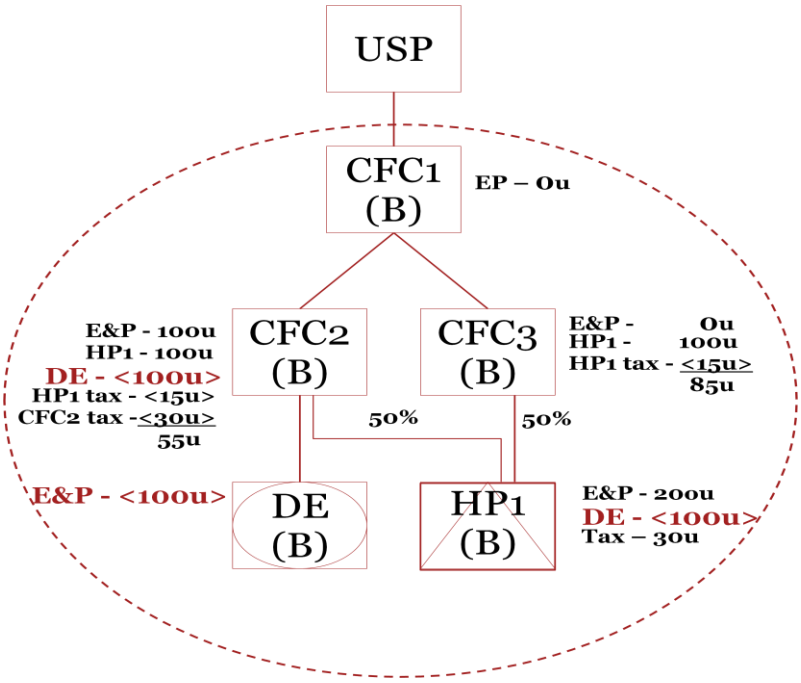
Figure 7



Country A Group - 30% Tax Rate

Figure 8 below (Temp. Treas. Reg. §1.909-2T(b)(2)(viii), Example 1) is an example from the regulations illustrating a more complex loss-sharing splitter arrangement.

Figure 8



Country B Group - 30% Tax Rate

***Observation*:** The rules on group relief splitter arrangements are one of the two categories (along with consolidated groups) that are likely to have the greatest impact on US multinational groups. The temporary regulations have expanded substantially the scope of section 909's application to group relief regimes. The new rules may apply to group relief regimes (primarily the UK), where disregarded entities under a US company have foreign taxable income that could be offset by the loss being surrendered. Notice 2010-92 essentially confined group loss-sharing splitter arrangements to those involving disregarded interest payments, but the temporary regulations include FTC splitting arrangements involving other types of loss surrender situations, including operating losses.

1. *Hybrid instruments*

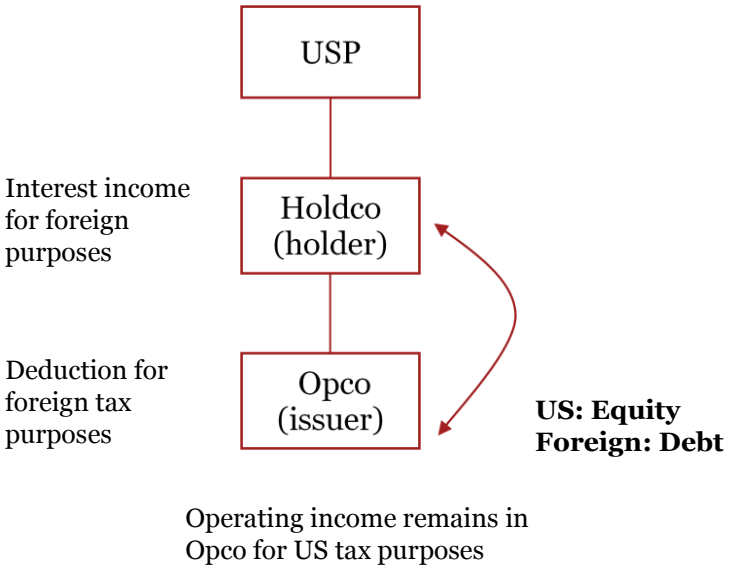
Temp. Treas. Reg. §1.909-2T(b)(3) generally treats hybrid instrument splitter arrangements the same way as Notice 2010-92, although (as was the case for reverse hybrids), the scope is expanded to cover taxes paid or accrued by persons other than section 902 corporations.

Notice 2010-92 applies section 909 to certain pre-2011 situations involving hybrid instruments, defined as instruments that are either (1) treated as equity for US federal income tax purposes but as debt for foreign tax purposes or (2) treated as debt for US federal income tax purposes but as equity for foreign tax purposes.

Under Temp. Treas. Reg. §1.909-2T(b)(3)(i), a US equity hybrid instrument is a splitter arrangement if: (1) foreign income taxes are paid or accrued by the owner of a US equity hybrid instrument with respect to payments or accruals on or with respect to the instrument, (2) such payments are deductible by the issuer under the laws of a foreign jurisdiction in which the issuer is subject to tax, and (3) such payments do not give rise to income for US Federal income tax purposes. Thus, the definition no longer requires that the instrument be treated as debt for foreign purposes. Split taxes under such an arrangement are equal the total amount of foreign income taxes, including withholding taxes, paid or accrued by the owner of the hybrid instrument less the amount of foreign income taxes that would have been paid or accrued had the owner of the US equity hybrid instrument not been subject to foreign tax on income from the instrument. The related income is income of the issuer of the US equity hybrid instrument equal to the payments or accruals giving rise to the split taxes that are deductible by the issuer for foreign tax purposes (regardless of the issuer's income or E&P for US federal income tax purposes).

Figure 9 below illustrates a US equity hybrid instrument splitter arrangement.

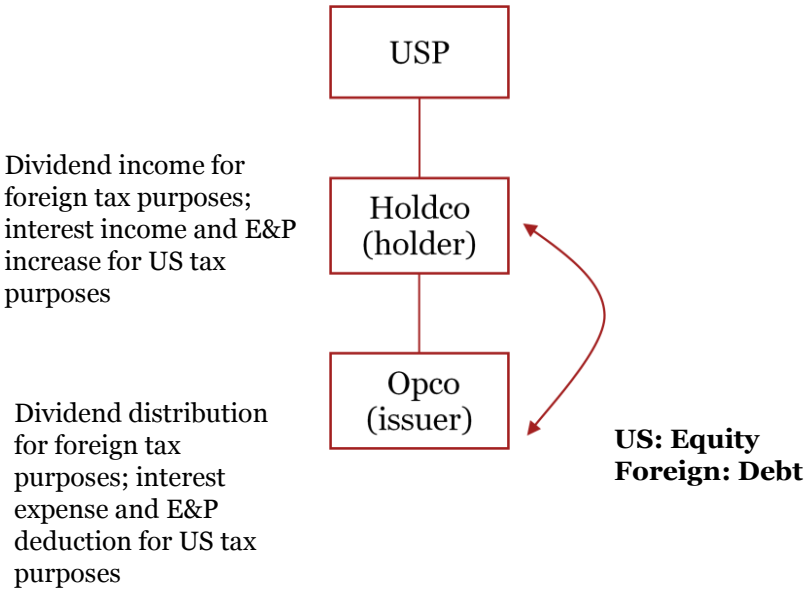
Figure 9



Temp. Treas. Reg. §1.909-2T(b)(3)(ii)(D) provides that a US debt hybrid instrument is a splitter arrangement to the extent that the foreign income taxes are paid or accrued by the issuer of a US debt hybrid instrument with respect to income in an amount equal to the interest (including original issue discount) paid or accrued on the instrument that is deductible for US federal income tax purposes but that does not give rise to a deduction under the laws of a foreign jurisdiction in which the issuer is subject to tax. Split taxes from such an arrangement are the foreign income taxes paid or accrued by the issuer on the income that would have been offset by the interest paid or accrued on the US debt hybrid instrument had such interest been deductible for foreign tax purposes. The related income is the gross amount of the interest income recognized for US federal income tax purposes by the owner of the US debt hybrid instrument.

Figure 10 below illustrates a US debt hybrid instrument splitter arrangement.

Figure 10



***Observation*:** As was the case with Notice 2010-92, the application of section 909 to US debt hybrid instruments is somewhat surprising, but such instruments are generally much less common than US equity hybrid instruments.

1. *Partnership inter-branch payments*

As foreshadowed in Notice 2010-92, §5.03, Temp. Treas. Reg. §1.909-2T(b)(4) describes a partnership inter-branch payment splitter arrangement, under which allocations described in former Treas. Reg. §1.704-1(b)(4)(viii)(d)(3) (removed by the new section 704 temp regs, effective 2012) result in an FTC splitting event in post-2010 taxable years to the extent such allocations result in foreign income taxes being allocated to a different partner than the related income.

The basic principle applied in Temp. Treas. Reg. §1.909-2T(b)(4) is that an allocation of foreign income tax paid or accrued by a partnership with respect to an inter-branch payment is a splitter arrangement to the extent that tax is not allocated to the partners in the same proportion as the distributive shares of income in the creditable foreign tax expenditure ("CFTE") category to which the tax payment is or would otherwise be assigned under Treas. Reg. §1.704-1(b)(4)(viii)(d) (as amended by the new section 704 regulations). Split taxes from a partnership inter-branch payment splitter arrangement equal the excess of the amount of the inter-branch payment tax allocated to a partner under the partnership agreement over the amount of the inter-branch payment tax that would have been allocated to the partner if the tax had been allocated in the same proportion as the distributive shares of income in that CFTE category. Related income from a partnership inter-branch payment splitter arrangement equals the amount of income allocated to a partner that exceeds what would have been allocated to that partner if income in that CFTE category in the amount of the inter-branch payment had been allocated to the partners in the same proportion as the inter-branch payment tax was allocated under the partnership agreement.

Figures 11 and 12 below illustrate the application of the partnership inter-branch payment rules of the section 704 regulations. Note that they do not illustrate splitter arrangements, but rather the proper operation of the inter-branch payment rules.

Figure 11

(Temp. Treas. Reg. § 1.704-1T(b)(5), Example 24, (i) and (ii))

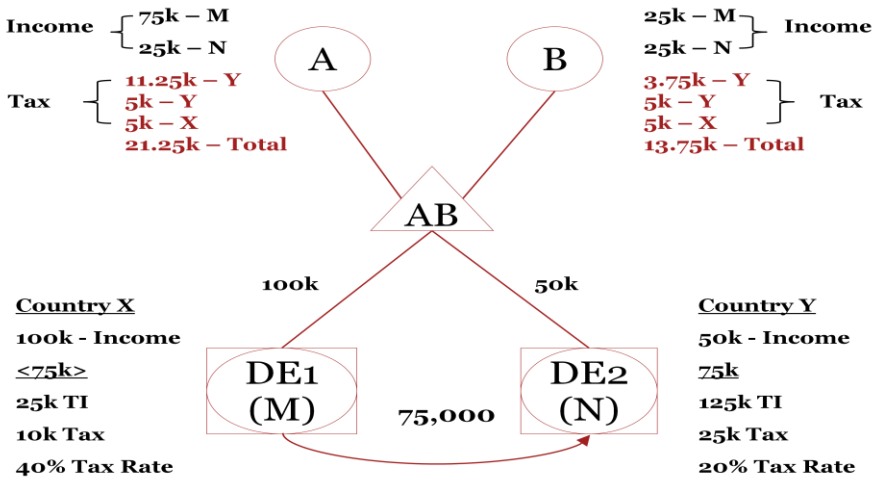
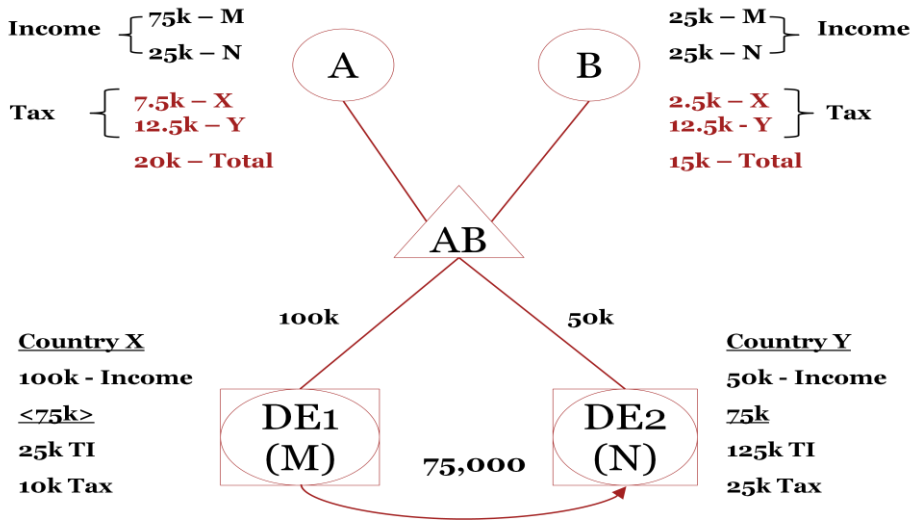


Figure 12

(Temp. Treas. Reg. § 1.704-1T(b)(5), Example 24, (iii))



***Observation*:** This provision essentially neutralizes some of the FTC benefits available in a "tracker" partnership structure with disregarded entities below the partnership by reallocating the foreign tax associated with payments between those entities back to the payor.

2. *Foreign consolidated groups*

Under the temporary section 909 regs, consolidated groups continue to be treated as splitters until taxable years beginning after 2/14/12. The temporary regulations do not provide any new or separate definition of foreign consolidated group splitter arrangements; instead, they simply adopt the definition from Notice 2010-92, as incorporated into Temp. Treas. Reg. 1.909-6T(b)(2). Thus, the regulations state that a foreign consolidated group exists when a foreign country imposes tax on the combined income of two or more entities. Tax is considered imposed on the combined income of two or more entities even if the combined income is computed under foreign law by attributing to one such entity the income of one or more entities. A foreign consolidated group is a splitter arrangement to the extent that the taxpayer does not allocate the foreign consolidated tax liability among the members of the foreign consolidated group under the principles of former Treas. Reg. §1.901-2(f)(3).

Split taxes result from such arrangements to the extent that taxes paid or accrued by one member of the foreign consolidated group are imposed on another covered person's share of the consolidated taxable income in the foreign tax base. The related income is the E&P of the covered person attributable to the activities giving rise to income in the foreign tax base for which the split taxes were paid or accrued.

***Observation*:** The operative rule going forward for taxable years beginning after 2/14/12 is the pro-rata rule under new Treas. Reg. § 901-2(f)(3). However, taxpayers have the flexibility of applying that rule for tax years beginning on or after January 1, 2011, and on or before February 14, 2012. The rules here backstop the positions that the IRS has taken previously, as in (unsuccessfully) the *Guardian Industries* case.

Anticipated future guidance

The preamble to the temporary regulations makes clear that the Treasury Department and the IRS will continue to refine and expand the application of section 909 in future guidance. They are looking at transactions that can result in the separation of foreign income taxes and the related income because of differences in when a shareholder is taxed on a dividend out of earnings of a covered person (for example, a distribution that is a dividend for foreign tax purposes but is disregarded or not includible for US federal income tax purposes).

The preamble also signals that additional regulations are anticipated under section 909 that will, among other things, provide guidance on the treatment of related income and split taxes in the case of dispositions that were not described in Notice 2010-92, §4.06 (specifically, transactions that do not qualify under section 381). Until those regulations are issued, the principles of Temp. Treas. Reg. §1.909-6T(d)-(f) (which incorporate Notice 2010-92, §4.06) will apply to related income and split taxes in taxable years beginning on or after January 1, 2011 -- except for the alternative "related income first" method for identifying distributions of related income, as noted above.

Regulations are also promised on the interaction between section 909 and other provisions, such as sections 904(c), 905(a), and 905(c). In the meantime, Temp. Treas. Reg. §1.909-6T(g) (incorporating of Notice 2010-92, §6) will apply to post-2010 tax years.

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