REGULATIONS WOULD ADDRESS FOREIGN TAX CREDIT PLANNING FOR E.U. STATE AID ADJUSTMENTS

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INTRODUCTION

The Internal Revenue Service ("I.R.S.") recently issued a notice[1] stating that it intends to issue regulations to address two new categories of foreign tax credit splitter arrangements that may be implemented by a taxpayer as a result of foreign-initiated adjustments.

Although the notice is not expressly limited to foreign-initiated adjustments arising from European Union ("E.U.") State Aid decisions, the I.R.S. notice reflected concern that U.S.-based multinational groups might attempt to revise global structures in advance of a payment in order to maximize subsequent foreign tax credits under Code §902 at the time a dividend is received by a U.S. shareholder. As a cautionary note, the I.R.S. cautioned that the notice cannot be taken to infer that payments made pursuant to any particular foreign-initiated adjustment, including those arising under E.U. State Aid investigations by the European Commission, are creditable taxes.

FOREIGN TAX CREDIT BASICS

Under Code §901, and subject to the limitations of Code §904 discussed below, a U.S. person (*e.g.*, a U.S. citizen, a U.S. corporation) can elect to claim a credit for foreign income taxes paid or accrued to a foreign country or a U.S. possession. The foreign tax credit under Code §901 is a direct credit because the foreign income tax is paid or accrued by the U.S. person.

Under Code §902, if a U.S. corporation receives a dividend during the tax year from a foreign corporation in which it owns at least 10% of the voting stock, the U.S. corporation can elect to claim a credit for the foreign income taxes paid by the foreign corporation, which are related to earnings that generate the dividend. The U.S. corporation will be deemed to have paid the same proportion of the foreign corporation's post-1986 foreign income taxes as the amount of the dividend bears to the foreign corporation's pool of post-1986 undistributed earnings. The foreign tax credit under Code §902 is an indirect or deemed paid credit.[2]

Under Code §904, the foreign tax credit is limited so that the credit can be applied only on U.S. income tax attributable to foreign-source net taxable income of the corporate shareholder. This limitation serves the purpose of preventing a U.S.

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1 Notice 2016-52, I.R.B. 2016-40.

2 Further, under Code §960, a U.S. corporation may claim a credit under Code §902 for a dividend it was deemed to have received during the tax year as a result of the gross income inclusion rules applicable to controlled foreign corporations.

person from offsetting U.S. income tax on U.S.-source income with a tax credit for foreign income taxes. Further, Code §904 separates foreign income into different categories (*i.e.*, the passive category and the general category) in order to prevent the averaging of low foreign withholding tax rates, which typically apply to passive foreign income (nil for interest and royalties and nil, 5%, or 15% for dividends), and high foreign income tax rates, which typically apply to foreign income derived from an operating business, when computing benefits under the foreign tax credit.

FOREIGN-INITIATED ADJUSTMENTS

When a foreign tax authority re-determines or adjusts foreign income taxes in a tax year after a U.S. person has claimed a foreign tax credit attributable to those foreign income taxes, the rules of Code §905(c) apply. In general, if any adjustment affects a direct tax under Code §901 (*e.g.*, a refund or reduction of a withholding tax) a U.S. person is required to file an amended return to reflect the adjustment. Adjustments to foreign income taxes imposed on subsidiaries and claimed as indirect credits under Code §902 are generally taken into account prospectively by making appropriate adjustments to the pools of post-1986 foreign incomes taxes and the pools of post-1986 undistributed earnings. When the adjustments are made the last day of the second full taxable year succeeding the accrual year, refunds cannot be made. Instead, the pool of undistributed earnings and the pool of creditable foreign tax credits are adjusted and may be used going forward.

For example, if a foreign subsidiary, which paid a dividend to its U.S. parent in Tax Year 1, is assessed a higher income tax for Tax Year 1 and pays the assessment in Tax Year 3, its U.S. corporate parent would generally not be able to file an amended return for Tax Year 1 in order to receive a higher foreign tax credit. Instead, the U.S. corporate parent would have to adjust the pools of post-1986 foreign income taxes used to calculate its indirect foreign tax credit. The pool of foreign income taxes paid or accrued by the foreign subsidiary would be increased and the pool of undistributed earnings would be decreased. Such an adjustment may affect the U.S. corporate parent's foreign tax credit in Tax Year 3, presumably increasing the foreign tax credit that attaches to each dollar of dividend received.

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FOREIGN TAX CREDIT SPLITTER ARRANGEMENTS

Enacted in 2010, Code §909 is aimed at preventing situations in which foreign income taxes have been separated or "split" from the related income. That is, foreign tax credits have been made available to a U.S. person but the underlying income is not yet subject to U.S. Federal income tax.

Under Code §909(a), if there is a "foreign tax credit splitting event" ("F.T.C.S.E.") with respect to a foreign income tax paid or accrued by a taxpayer, such foreign income tax will not be taken into account for U.S. Federal income tax purposes before the tax year in which the related income is taken into account by the taxpayer. That is, the accelerated taxes that are split off from the deferred income are suspended until there is a matching of the foreign tax credits and the related inclusion of income.

Under Code §909(b), if there is a F.T.C.S.E. with respect to foreign income tax paid or accrued by a Code §902 corporation (defined below), that foreign income tax will not be taken into account for the purposes of Code §902 (nor for the purposes of

Code §§960 and 964(a)) before the tax year in which the related income is taken into account for U.S. Federal income tax purposes by the Code §902 corporation or a U.S. corporation that owns the Code §902 corporation in the manner described in Code §§902(a) and (b) (*i.e.*, the U.S. corporation must own at least 10% of the voting stock in the case of a first-tier foreign corporation).

For the purposes of Code §§909(a) and (b), "related income" means, with respect to any portion of the foreign income tax, the income (or earnings and profits) to which the portion of the foreign income tax relates.

"The regulations announced in the notice would add two new categories of foreign tax credit splitter arrangements."

A Code §902 corporation is (i) a first-tier foreign corporation in which a U.S. corporation owns 10% of the voting stock or (ii) a lower-tier foreign corporation in which a U.S. corporation owns at least 5% of the voting stock indirectly through a chain of foreign corporations connected through stock ownership of at least 10% of their voting stock.[3]

The Treasury regulations provide an exclusive list of four splitter arrangements that give rise to an F.T.C.S.E.: (i) reverse hybrid structures, (ii) loss-sharing, (iii) hybrid instruments, and (iv) partnership inter-branch payments.

The case of a reverse hybrid involves an entity that is treated as a corporation for U.S. Federal income tax purposes and a pass-through entity for foreign income tax purposes. An example is a foreign partnership that is tax transparent in the jurisdiction where organized but is treated as a corporation for U.S. income tax purposes because of a check-the-box election. If the reverse hybrid earns income from a foreign business, the foreign tax will be imposed on its U.S. parent corporation since it is a pass-through entity under foreign law. However, under Code §909, the foreign income taxes are not taken into account for U.S. Federal income tax purposes until the underlying income of the reverse hybrid becomes taxable in the U.S. Since it is a corporation for U.S. Federal income tax purposes, that event will occur when, for example, the reverse hybrid pays a dividend to the U.S. parent.

FOREIGN-INITIATED ADJUSTMENT SPLITTER ARRANGEMENTS

The regulations announced in the notice would add two new categories of foreign tax credit splitter arrangements, referred to as "foreign-initiated adjustment splitter arrangements." For the purposes of the new regulations, a "foreign-initiated adjustment" would be a foreign-initiated adjustment (or series of related adjustments to more than one tax year) that results in additional foreign income tax liability of greater than the foreign currency equivalent of U.S. $10 million.

The new regulations would seek to prevent the following planning. Before a payment is made pursuant to a foreign-initiated adjustment, a taxpayer attempts to change its ownership structure or cause the Code §902 corporation to make an extraordinary distribution so that the subsequent tax payment creates a high-tax pool of post-1986 undistributed earnings that can be used to generate substantial amounts of foreign taxes deemed paid, without repatriating and including in U.S. taxable income the earnings and profits to which the taxes relate.

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[3] Code §909(d)(5).

The new regulations would apply similar rules to taxpayers that take the position that taxes paid by a U.S. person pursuant to a foreign-initiated adjustment to the tax liability of a Code §902 corporation are eligible for a direct foreign tax credit under Code §901.

Splitter Arrangements Arising from the Application of Code §905(c) to Successor Entities

The new regulations would provide that a splitter arrangement arises when, as a result of a "covered transaction" (defined below), a Code §902 corporation pays "covered taxes" (defined below) during a tax year, that is, the "splitter year."

For the purposes of the notice, "covered taxes" are foreign income taxes that

- are taken into account by adjusting the payor's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the tax year under Code §905(c), and
- result from a specified foreign-initiated adjustment (*i.e.*, an adjustment resulting in foreign income taxes greater than the foreign currency equivalent of $10 million) to the amount of foreign income tax accrued with respect to one or more prior tax years, referred to as the "relation-back years."

A "covered transaction" generally would be any transaction (or series of related transactions) that meets the following conditions:

- The transaction results in covered taxes being paid by a payor that is a Code §902 corporation but is not the Code §902 corporation that would have been the payor of the covered taxes (*i.e.*, the predecessor entity) if the covered taxes had been paid or accrued in the relation-back year.
- The predecessor[4] entity was a "covered person" (essentially, a related person) with respect to the payor immediately before the transaction, or, if the payor did not exist immediately before the transaction, the predecessor entity was a covered person with respect to the payor immediately after the transaction.

Reflecting a no-harm, no-foul approach, a covered transaction would not include a transaction in which the payor (*i.e.*, the successor Code §902 corporation) also succeeds to the earnings and profits of the predecessor entity under Code §381(c)(2) (relating to carryovers of earnings and profits in certain corporate acquisitions), nor would it include a case in which the taxpayer can demonstrate by clear and convincing evidence that the transaction was not structured with a principal purpose of separating covered taxes from the post-1986 undistributed earnings of the predecessor entity that include the earnings to which the covered taxes relate.

The new regulations would provide a definition for the term "related income" applicable to this first new category of foreign tax credit splitter arrangement. Related income would equal the sum of the portions of the predecessor entity's earnings and profits for each of the relation-back years that meet all of the following conditions:

- The earnings and profits are described in Code §316(a)(2) relating to dividends made out of current earnings and profits.

[4] The term "predecessor entity" would include a successor of the predecessor entity.

- The earnings and profits are included in the foreign tax credit pool under Code §904 to which the covered tax is assigned.
- The earnings and profits are attributable to all activities that gave rise to the income (computed under foreign law) included in the foreign tax base that was adjusted pursuant to the specified foreign-initiated adjustment, regardless of which activities gave rise to the adjustment.

Splitter Arrangements Arising from Distributions Made Before the Payment of Additional Tax Pursuant to Foreign-Initiated Adjustments

The notice stated that taxpayers could achieve a similar result by using distributions to move post-1986 undistributed earnings from one Code §902 corporation to another Code §902 corporation before the first one makes a tax payment as a result of a foreign-initiated adjustment.

In the case of such a distribution, the earnings to which the tax payment relates are first taken into account by the payor but, as a result of the distributions, are then taken into account by a covered person that is a Code §902 corporation ("a section 902 covered person"), before the first Code §902 corporation pays the tax.

The regulations would provide that a splitter arrangement results when a payor that is a Code §902 corporation pays covered taxes during a tax year (*i.e.*, the splitter year) and the payor has made a "covered distribution." A "covered distribution" is any distribution, with respect to the payor's stock, to the extent such distribution

- occurred in a tax year of the payor to which the covered taxes relate or any subsequent tax year up to and including the tax year immediately before the tax year in which the covered taxes are paid,
- resulted in a distribution or allocation of the payor's post-1986 undistributed earnings (which, for this purpose, does not include earnings and profits attributable to income effectively connected with the conduct of a U.S. trade or business or otherwise subject to U.S. Federal income tax in the hands of the payor) to a section 902 covered person, and
- was made with a principal purpose of reducing the payor's post-1986 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes.

A distribution will be presumed to have been made with the principal purpose of reducing the payor's post-1986 undistributed earnings if the sum of all distributions that would be covered distributions (without regard to the principal purpose requirement) is greater than 50% of the sum of (i) the payor's post-1986 undistributed earnings as of the beginning of the payor's tax year in which the covered tax is paid, and (ii) the sum of all distributions that would be covered distributions without regard to the principal purpose requirement.

The presumption is rebutted only by clear and convincing evidence that the distribution was not made with the principal purpose of reducing the payor's post-1986 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes.

For the purpose of this second new category of foreign tax credit splitter arrangement,

"related income" is determined by first determining the "initial related income," which would be the sum of the portions of the payor's earnings and profits for each relation-back years that

- are described in Code §316(a)(2) (relating to dividends made out of current earnings and profits),
- are in the foreign tax credit pool under Code §904 to which the covered tax is assigned, and
- are attributable to all activities that gave rise to the income (computed under foreign law) included in the foreign tax base that was adjusted pursuant to the specified foreign-initiated adjustment, regardless of which activities gave rise to the adjustment.

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