Foreign Tax Credit Guidance under Section 909 Related to Foreign-Initiated Adjustments

Notice 2016-52

SECTION 1. OVERVIEW

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue regulations under section 909 to address the separation of related income from foreign income taxes paid by a section 902 corporation (as defined in section 909(d)(5)) pursuant to a foreign-initiated adjustment. Under section 905(c), certain foreign income taxes paid by a section 902 corporation after the taxable year to which the taxes relate generally are taken into account by adjusting section 902 pools of post-1986 foreign income taxes in the taxable year in which the taxes are paid, rather than accounting for the taxes in the prior taxable year to which the taxes relate. The Treasury Department and the IRS are aware that, in anticipation of a large foreign-initiated adjustment that relates to a prior taxable year, a taxpayer may take steps to separate the additional payment of foreign income tax from the income to which it relates. Such foreign-initiated adjustments may arise under European Union (EU) State aid law, to the extent EU State aid payments result in creditable foreign taxes. Specifically, before a payment is made pursuant to a foreign-initiated adjustment, a taxpayer may attempt to change its ownership structure or cause the section 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.

The Treasury Department and the IRS have determined that guidance to address these transactions is appropriate under section 909, which is intended to prevent the separation of creditable foreign taxes from related income generally by deferring the right to claim credits until the related income is included in U.S. taxable income. Accordingly, this notice announces that the Treasury Department and the IRS intend to issue regulations under section 909 that will identify two new splitter arrangements relating to section 902 corporations that pay foreign income taxes pursuant to foreign-initiated adjustments. The regulations will 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 section 902 corporation are eligible for a direct foreign tax credit under section 901.

No inference is intended from this notice as to the treatment of transactions described in this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines. In addition, no inference is intended under this notice as to whether (1) payments made pursuant to any particular foreign-initiated adjustment, including those arising under EU State aid law, qualify as payments of creditable foreign income taxes, or (2) taxes paid by a U.S. person pursuant to a foreign-initiated adjustment to the tax liability of a section 902 corporation are eligible for a direct foreign tax credit under section 901.

SECTION 2. BACKGROUND

.01 *Application of Section 905(c) to Taxes Paid by Section 902 Corporations Pursuant to Foreign-Initiated Adjustments*

If a foreign income tax liability for a prior year changes, section 905(c)(1) generally requires the taxpayer to notify the Secretary, who will redetermine the amount of the U.S. tax for the year or years affected. In the case of foreign income taxes deemed paid under section 902 or 960, section 905(c)(1) also authorizes the Secretary to prescribe adjustments to section 902 pools of post-1986 foreign income taxes and post-1986 undistributed earnings in lieu of redetermining the U.S. shareholder's U.S. tax. If accrued foreign taxes of a section 902 corporation are paid more than two years after the close of the taxable year to which such taxes relate, section 905(c)(2)(B)(i)(I) provides that such taxes are taken into account in the taxable year in which the foreign taxes are paid. Temporary and proposed regulations issued in 1988 and 2007 implemented these rules. *See* §1.905-3T (2007). Portions of the temporary regulations expired on November 5, 2010, but remain outstanding in proposed form. Neither section 905(c) nor the regulations under that section specifically address how to account for additional payments of foreign income tax with respect to earnings of a section 902 corporation if, as the result of a liquidation, reorganization, or other corporate transaction, the person that makes an additional payment of tax pursuant to a foreign-initiated adjustment is different from the section 902 corporation that would have paid the tax had it been paid in the year to which the additional tax relates.

.02 *Foreign Tax Credit Splitter Arrangements under Section 909*

Section 909(a) provides that, if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a taxpayer, such tax will not be taken

into account before the taxable year in which the related income is taken into account by the taxpayer.

Section 909(b) provides that, if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a section 902 corporation, such tax is not taken into account for purposes of section 902 or 960, or for purposes of determining earnings and profits under section 964(a), before the taxable year in which the related income is taken into account by the section 902 corporation or a domestic corporation that meets the ownership requirements of section 902(a) or (b) with respect to the section 902 corporation. Section 909(c)(1) provides that sections 909(a) and (b) apply at the partner level. *See also* §1.909-1(b).

Section 909(d)(3) provides that the term "related income" means, with respect to any portion of any foreign income tax, the income (or, as appropriate, earnings and profits) to which such portion of the foreign income tax relates.

Section 909(d)(1) provides that there is a foreign tax credit splitting event with respect to a foreign income tax if the related income is (or will be) taken into account by a covered person.

Regulations under section 909 narrow the statutory definition in section 909(d)(1) to provide that there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued only if, in connection with a "splitter arrangement," the related income was, is, or will be taken into account for U.S. federal income tax purposes by a person that is a covered person (as defined in §1.909-1(a)(4)) with respect to the payor of the tax. §1.909-2(a)(1). The term "payor" means a person that pays or accrues a foreign income tax within the meaning of §1.901-2(f), as well as a

person that takes foreign income taxes paid or accrued by a partnership into account pursuant to section 702(a)(6). §1.909-1(a)(3).

Section 1.909-2(b) provides an exclusive list of splitter arrangements and identifies the split taxes and related income for each such arrangement. The preamble to the final regulations under section 909 states that the Treasury Department and the IRS will continue to consider other arrangements that inappropriately separate foreign income taxes from the related income. TD 9710, 80 FR 7323.

Section 1.909-2(a)(2) provides that split taxes are not taken into account for U.S. federal income tax purposes before the taxable year in which the related income is taken into account by the payor or, in the case of split taxes paid or accrued by a section 902 corporation, by a section 902 shareholder (as defined in §1.909-1(a)(2)) of the section 902 corporation.

Section 909(e) authorizes the Secretary to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 909.

SECTION 3. FOREIGN-INITIATED ADJUSTMENT SPLITTER ARRANGEMENTS

.01 *Splitter Arrangements Arising from the Application of Section 905(c) to Successor Entities*

This section 3.01 describes regulations that the Treasury Department and the IRS intend to issue in order to address changes in ownership structures that, in connection with a foreign-initiated adjustment, result in a foreign tax credit splitting event. These regulations will provide that a splitter arrangement arises when, as a result of a "covered transaction," a section 902 corporation pays "covered taxes" during a taxable year (the "splitter year").

For purposes of this notice, “covered taxes” are foreign income taxes that:

(1) are taken into account by adjusting the payor’s pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the taxable year paid pursuant to section 905(c); and

(2) result from a “specified foreign-initiated adjustment” to the amount of foreign income tax accrued with respect to one or more prior taxable years (“relation-back years”).

A “specified foreign-initiated adjustment” is a foreign-initiated adjustment (or series of related adjustments to more than one taxable year) that results in additional foreign income tax liability that is greater than $10 million, regardless of whether such liability is actually paid in one or more taxable years (due, for example, to an installment plan).

A “covered transaction” generally is any transaction or series of related transactions that meet the following conditions:

(1) The transaction or series of related transactions results in covered taxes being paid by a payor that is a section 902 corporation and that is not the section 902 corporation that would have been the payor of the covered taxes (the predecessor entity) if the covered taxes had been paid or accrued in the relation-back year; and

(2) The predecessor entity (or a successor of the predecessor entity) was a covered person with respect to the payor immediately before the transaction or series of related transactions, or, if the payor did not exist immediately before the transaction or series of related transactions, the predecessor entity

(or a successor of the predecessor entity) was a covered person with respect to the payor immediately after the transaction or series of related transactions.

However, a transaction or series of related transactions will not be treated as a covered transaction if either of the following exceptions applies:

(1) The transaction or series of related transactions results in the transfer of the earnings and profits of the predecessor entity to the payor pursuant to section 381(c)(2); or

(2) The taxpayer demonstrates by clear and convincing evidence that the transaction or series of related transactions were 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.

In the case of a splitter arrangement described in this section 3.01, “related income” equals the sum of the portions of the predecessor entity’s earnings and profits for each of the relation-back years that are:

(1) described in section 316(a)(2) (“section 316(a)(2) earnings”);

(2) in the separate category or categories to which covered tax is assigned; and

(3) attributable to all activities that gave rise to income (computed under foreign law) included in the foreign tax base that was adjusted pursuant to the specified foreign-initiated adjustment (“adjusted foreign tax base”), regardless of which particular activities gave rise to the adjustment.

If foreign income tax is imposed on the combined income (within the meaning of §1.901-2(f)(3)(ii)) of two or more entities, including for this purpose disregarded entities, the principles of these rules will apply on an entity-by-entity basis.

The principles of §1.909-6(d) will apply to determine the amount of related income of the predecessor entity that is transferred to other persons or taken into account by a section 902 shareholder or the payor section 902 corporation (for example, due to a transaction that is described in section 381(a)(1) or (a)(2)) in any relation-back year or subsequent year before the splitter year.

In the case of a splitter arrangement described in this section 3.01, "split taxes" are the amount of the covered taxes that relate to the predecessor entity's related income that was not transferred to the payor in the covered transaction, reduced by the ratable portion of the covered taxes that would no longer be treated as split taxes under the principles of §1.909-6(e)(4) because a section 902 shareholder or the payor section 902 corporation took related income into account prior to the splitter year.

The following example illustrates the regulations described in this section 3.01. All dollar amounts in this example are in millions.

Example. (i) Facts. USP, a domestic corporation, wholly owns CFC1. CFC1 wholly owns CFC2. CFC1 and CFC2 are foreign corporations that were formed at the beginning of Year 1, are residents of Country X, and use the U.S. dollar as their functional currency. CFC1 wholly owns DE, a disregarded entity for U.S. federal income tax purposes that is organized in Country X and treated as a corporation for Country X tax purposes. CFC1 does not earn any income or pay any foreign taxes, other than through DE. For each of Years 1 through 5, DE earns $200 of earnings and profits with respect to which it accrues and pays no foreign tax. These earnings and profits constitute CFC1's pool of post-1986 undistributed earnings, which equals $1,000 as of the end of Year 5. The earnings and profits are all in the general income category. In Year 6 (a year when DE earns no income), CFC1 transfers all of its interest in DE to CFC2 in exchange for CFC2 stock in a transaction that qualifies under section 351. In Year 8, after exhausting all effective and practical remedies to minimize its liability for

Country X tax, DE pays $200 in foreign income taxes to Country X to settle a series of related adjustments proposed by Country X with respect to Years 1 through 5.

(ii) Splitter arrangement. CFC1's transfer of its interest in DE to CFC2 in Year 6 and the payment of foreign income taxes by CFC2 through DE in Year 8 will give rise to a splitter arrangement under the rules described in section 3.01 of this notice, unless USP satisfies the principal purpose exception. The $200 of foreign income taxes paid by CFC2 are covered taxes because (1) they are added to CFC2's pool of post-1986 foreign income taxes in Year 8 pursuant to section 905(c), and (2) they result from a specified foreign-initiated adjustment with respect to one or more relation-back years. Unless USP establishes by clear and convincing evidence that the transfer of CFC1's interest in DE to CFC2 was not structured with a principal purpose of separating covered taxes from the post-1986 undistributed earnings of CFC1 that include the earnings to which the covered taxes relate, that transfer is a covered transaction because (1) it resulted in CFC2 being the payor of the covered taxes and CFC1 would have been the payor of the covered taxes if they were paid or accrued in the relation-back years; (2) immediately before the transfer, CFC1 was a covered person with respect to CFC2; and (3) the transfer did not result in a transfer of CFC1's earnings and profits to CFC2 pursuant to section 381(c)(2).

(iii) Related income. The related income equals $1,000, the sum of CFC1's section 316(a)(2) earnings with respect to each of Years 1 through 5 that are attributable to the activities of DE that gave rise to income (computed under foreign law) included in the adjusted foreign tax base of DE. Because CFC1 made no distributions before Year 8, the full amount of the related income remains in CFC1's pool of post-1986 undistributed earnings as of the beginning of Year 8, the splitter year.

(iv) Split taxes. The split taxes equal $200, the amount of the covered taxes paid by CFC2.

.02 *Splitter Arrangements Arising From Distributions Made Before the Payment of Additional Tax Pursuant to Foreign-Initiated Adjustments*

Taxpayers could achieve a result similar to the arrangement described in section 3.01 of this notice by using distributions to, in effect, move post-1986 undistributed earnings from one section 902 corporation to another section 902 corporation before the first section 902 corporation makes a tax payment pursuant to a specified foreign-initiated adjustment. In such a case, 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 section 902 corporation ("section 902 covered person") before the first section 902 corporation pays the tax. Accordingly, the Treasury Department and the IRS intend to issue regulations that will provide that a splitter arrangement results when a payor that is a section 902 corporation pays covered taxes (as defined in section 3.01 of this notice) during a taxable year (the "splitter year"), and the payor (or a predecessor of 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:

(1) Occurred in a taxable year of the payor to which the covered taxes relate or any subsequent taxable year up to and including the taxable year immediately before the taxable year in which the covered taxes are paid;

(2) Resulted in a distribution or allocation (for example, pursuant to §1.312-10) of the payor's post-1986 undistributed earnings (but for this purpose not including earnings and profits attributable to income effectively connected with the conduct of a trade or business within the United States or otherwise subject to tax under chapter 1 in the hands of the payor) to a section 902 covered person; and

(3) 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 a principal purpose described immediately above if the sum of all distributions that would be covered

distributions without regard to the principal purpose requirement is greater than 50 percent of the sum of (i) the payor's post-1986 undistributed earnings as of the beginning of the payor's taxable 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. A taxpayer may rebut this presumption with clear and convincing evidence that the distribution was not 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. For example, a taxpayer may rebut this presumption by demonstrating that the distributions were consistent with the payor's pattern of distributions before the taxpayer reasonably anticipated the specified foreign-initiated adjustment. In the case of a distribution from a pool of post-1986 undistributed earnings that included earnings to which the covered taxes relate and earnings to which the covered taxes did not relate, a taxpayer may not rebut this presumption by claiming that the distribution reduced only the unrelated earnings.

In the case of a splitter arrangement described in this section 3.02, "related income" is determined by first determining the "initial related income" in the hands of the payor. The "initial related income" is the sum of the portions of the payor's earnings and profits for each of the relation-back years that are:

(1) section 316(a)(2) earnings;

(2) in the separate category or categories to which covered tax is assigned; and

(3) attributable to all activities that gave rise to income (computed under foreign law) included in the adjusted foreign tax base (as defined in section 3.01 of

this notice), regardless of which particular activities gave rise to the adjustment.

If foreign income tax is imposed on the combined income (within the meaning of §1.901-2(f)(3)(ii)) of two or more entities, including for this purpose disregarded entities, the principles of these rules will apply on an entity-by-entity basis.

Each covered distribution will be treated as resulting in a distribution of initial related income to the recipient on a pro rata basis under the principles of §1.909-6(d)(3). The recipient of initial related income in a covered distribution is treated as having taken into account "related income" in the taxable year in which the covered distribution was made. The principles of §1.909-6(d) will apply to determine the amount of related income of the recipient of the covered distribution that is transferred to other persons or taken into account by a section 902 shareholder or the payor section 902 corporation after the covered distribution was made, in a taxable year before the splitter year.

In the case of a splitter arrangement described in this section 3.02, "split taxes" are the covered taxes multiplied by a ratio, the numerator of which is the total amount of related income as of the beginning of the splitter year (appropriately reduced for any amounts taken into account prior to the splitter year by a section 902 shareholder or the payor section 902 corporation), and the denominator of which is the payor's (or any predecessor corporation's) initial related income.

The following examples illustrate the regulations described in this section 3.02. All dollar amounts in these examples are in millions.

Example 1. (i) Facts. USP, a domestic corporation, wholly owns CFC1. CFC1 wholly owns CFC2. CFC1 and CFC2 are foreign corporations that were formed at the

beginning of Year 1, are resident in Country X, and use the U.S. dollar as their functional currency. For each of Years 1 through 9, CFC2 earns $100 of earnings and profits with respect to which it does not accrue or pay any foreign income tax. In Year 10, CFC2 earns $120 of earnings and profits with respect to which it accrues and pays $20 of foreign income tax. Its post-1986 undistributed earnings as of the end of Year 10 are $1,000 (($100 x 9) + $120 – $20). On July 1, Year 11, CFC2 distributes $750 of its post-1986 undistributed earnings to CFC1. Pursuant to section 954(c)(6), CFC1's $750 of dividend income does not result in an income inclusion to USP. In Year 12, after having exhausted all available and practical remedies to minimize its liability for Country X tax, CFC2 pays $20 of foreign income tax to Country X with respect to each of Years 1 through 9 to settle related audit adjustments proposed by Country X. Pursuant to section 905(c), CFC2 adds $180 of additional tax relating to Years 1 through 9 to its pool of post-1986 foreign income taxes in Year 12. CFC2 does not earn any other income or pay any other foreign tax in Years 11 and 12. CFC2's post-1986 undistributed earnings as of the beginning of Year 12 are $250 ($1,000 – $750).

(ii) Splitter arrangement. The distribution of $750 to CFC1 in Year 11 and the payment of $180 of foreign income taxes in Year 12 will give rise to a splitter arrangement under section 3.02 of this notice, unless USP rebuts the presumption that the distribution was made with a principal purpose of reducing CFC2's post-1986 undistributed earnings in advance of the payment of the $180 of covered taxes. The $180 of foreign income taxes paid are covered taxes because (1) they are added to CFC2's pool of post-1986 foreign income taxes in Year 12 pursuant to section 905(c), and (2) they result from a specified foreign-initiated adjustment with respect to one or more relation-back years. The $20 of foreign income taxes previously accrued and paid with respect to Year 10 are not covered taxes because they did not result from a foreign-initiated adjustment. Unless USP establishes by clear and convincing evidence that the $750 distribution in Year 11 was not made with a principal purpose to reduce CFC2's post-1986 undistributed earnings in advance of the payment of covered taxes, the distribution is a covered distribution because it (1) occurred in or after Years 1 through 9, the relation-back years with respect to the covered taxes, and in a taxable year preceding Year 12, the year in which the covered taxes were paid, (2) resulted in a distribution of $750 of CFC2's post-1986 undistributed earnings to CFC1, a section 902 covered person with respect to CFC2, and (3) is presumed to have a principal purpose to reduce CFC2's post-1986 undistributed earnings in advance of the payment of covered taxes because it is greater than 50 percent of CFC2's post-1986 undistributed earnings as of the beginning of Year 12 plus the distribution ($750 > 0.50 x ($250 + $750)).

(iii) Related income. The initial related income in the hands of CFC2 is $900, which is the sum of CFC2's section 316(a)(2) earnings for Years 1 through 9, all of which were attributable to activities that gave rise to income included in the adjusted foreign tax base of CFC2. Under the principles of §1.909-6(d), the covered distribution of $750 in Year 11 results in a pro rata distribution of initial related income of $675 ($750 x ($900 / $1000)). Therefore, CFC1 is treated as taking into account related income equal to $675 in Year 11, the year of the covered distribution. Because CFC1

made no distributions in Year 11, the full amount of the related income remains in CFC1's pool of post-1986 undistributed earnings as of the beginning of Year 12, the splitter year.

(iv) Split taxes. The split taxes equal the covered taxes multiplied by a ratio, the numerator of which is the total amount of related income as of the beginning of the splitter year, and the denominator of which is the initial related income, or $135 ($180 x ($675/$900)).

Example 2. (i) Facts. The facts are the same as in Example 1, except that USP wholly owns CFC3, which wholly owns CFC1. CFC3 is a foreign corporation resident in Country X. In Year 11, CFC1 distributes $300 to CFC3. Pursuant to section 954(c)(6), CFC3's $300 of dividend income does not result in an income inclusion to USP.

(ii) Result. Because CFC1 made a distribution of $300 to CFC3 in Year 11, and CFC1's $750 of post-1986 undistributed earnings consisted of related income and other income, CFC1 is treated as having distributed $270 ($300 x ($675 / $750)) of related income to CFC3 under the principles of §1.909-6(d). Accordingly, as of the beginning of Year 12, CFC3 has $270 of related income and CFC1 has $405 of related income. The amount of split taxes remains $135.

.03 *Conforming Revisions*

Section 1.909-6(g)(3) provides that if a redetermination of foreign tax paid or accrued by a section 902 corporation occurs in a post-2010 taxable year and increases the amount of foreign income taxes paid or accrued by the section 902 corporation with respect to taxable years beginning on or before December 31, 2010 (a pre-2011 taxable year), such taxes will be treated for purposes of section 909 as being paid or accrued in a pre-2011 taxable year (pre-2011 taxes). Section 1.909-6(b) provides an exclusive list of splitter arrangements (which differs from the list provided in section 1.909-2(b)) that can give rise to foreign tax credit splitting events with respect to pre-2011 taxes. Section 1.909-6(g)(3) will be revised to provide that foreign tax redeterminations in a post-2010 taxable year with respect to pre-2011 taxes of a section 902 corporation in connection with a splitter arrangement described in section 3.01 or section 3.02 of this notice will not be treated as pre-2011 taxes for purposes of those sections.

SECTION 4. EFFECTIVE DATE

The regulations described in section 3 of this notice will apply to foreign income taxes paid on or after September 15, 2016.

SECTION 5. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS solicit comments on the rules described in this notice. In particular, the Treasury Department and the IRS solicit comments on whether the transactions addressed in section 3 of this notice would be more appropriately addressed pursuant to rules under section 905(c) providing that additional payments of tax be accounted for through adjustments to the pools of post-1986 foreign income taxes and post-1986 undistributed earnings of section 902 corporations that are not the same entity as the payor of the tax. The Treasury Department and the IRS also are considering whether an objective test, rather than a subjective test based on taxpayer intent, should be used to determine when the transactions described in sections 3.01 and 3.02 of this notice are treated as splitter arrangements. Accordingly, the Treasury Department and the IRS solicit comments on this issue, as well as on the types of objective tests that could be used for this purpose.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Jeffrey Parry, Internal Revenue Service, IR-4554, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.comments@irscounsel.treas.gov. Comments will be available for public inspection and copying. For further information regarding this notice, contact Mr. Parry of the Office of Associate Chief Counsel (International) at (202) 317-6936 (not a toll-free call).

Written or electronic comments must be received by December 14, 2016.