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The First Shoe Drops: Notice 2010-92 Provides Guidance on Section 909's Application to Pre-2011 Taxes

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Introduction

You have until the end of December to make some decisions about Section 909. To be more precise, you have until the end of the relevant Section 902 corporation's 2010 taxable year, which might provide more time. Section 909, the foreign tax credit anti-splitting rule, applies to foreign taxes paid or accrued in 2010 or earlier, if those taxes are deemed paid under section 902 or 960 in taxable years beginning after 2010. (It also, of course, applies to foreign taxes paid or accrued in taxable years beginning after 2010.) In other words, foreign taxes currently present in the foreign tax pools of a Section 902 corporation (including a CFC)[1] are subject to Section 909 if deemed paid under Section 902 or 960 in taxable years beginning after 2010, even if paid or accrued many years ago. But Section 909 does not apply to foreign taxes deemed paid before 2011 (i.e., before the relevant Section 909 corporation's 2011 tax year). So taxpayers have a decision to make: cause the foreign taxes in a Section 902 corporation's pools to be deemed paid before 2011 (and avoid Section 909's application to those taxes) or leave the foreign taxes in the Section 902 corporation's pools (and risk having Section 909 defer credit for those taxes—when they are otherwise deemed paid—until the related income is taken into account for U.S. tax purposes).

Section 909 essentially provides that if a foreign tax credit-splitting event occurs with respect to foreign income taxes, the foreign taxes will not be taken into account for U.S. tax purposes until the related income is taken into account for U.S. purposes by the U.S. taxpayer or, in the case of a Section 902 or 960 "deemed paid" credit, by either the Section 902 corporation that paid or accrued the foreign tax or by a "Section 902 shareholder" (that is, a U.S. corporation with sufficient ownership to claim a Section 902 credit). A foreign tax credit-splitting event occurs when "related income" is (or will be) taken into account for U.S. purposes by a "covered person," which essentially means a person related to the taxpayer. Taxpayers were hoping for guidance before 2011, to give them time to consider whether to distribute foreign taxes from their tax pools before Section 909's effective date. On December 6, only two months after the August 10 enactment of Section 909, Treasury and the IRS issued the first installment of that guidance in Notice 2010-92.

Claiming a deemed paid credit for such taxes after 2010 is, among other things, potentially a much more complicated process than if the taxes are deemed paid before 2011.

Contents of Notice 2010-92: Uncle Sam Wants YOU

In General

Notice 2010-92 states that regulations will be issued to provide that pre-2011 foreign taxes[2] paid or accrued by a Section 902 corporation "will not be suspended under Section 909" unless all four of the following criteria are met:

1. the taxes were paid or accrued in connection with one of four types of transactions or arrangements

described in the notice;
2. the taxes were not deemed paid under Section 902(a) or 960 before the Section 902 corporation's 2011 year;
3. the related income has not been taken into account, by either the Section 902 corporation that paid or accrued the foreign taxes or a Section 902 shareholder, before the Section 902 corporation's 2011 year; and
4. the taxes were paid or accrued in taxable years of the Section 902 corporation beginning after 1996.[3]

Four Types of Arrangements Set Forth in the Notice

The four types of arrangements that can cause pre-2011 foreign taxes to be suspended under Section 909 (the only arrangements treated as foreign tax credit-splitting events for such taxes) are the following:

1. a reverse hybrid (an entity treated as a corporation for U.S. tax purposes but as a pass-through entity by the relevant foreign country) owned by a Section 902 corporation;
2. foreign consolidated group structures, but only to the extent that the taxpayer has not allocated legal liability among the foreign consolidated group's members in accordance with each member's pro rata portion of the foreign tax base, under the principles of the joint and several liability rule of the current legal liability regulations;[4]
3. group relief or other loss sharing, but only if the shared loss is associated with a hybrid debt instrument that is disregarded for U.S. tax purposes; and
4. hybrid instruments that are treated as debt for U.S. tax purposes but as equity for foreign tax purposes, or vice versa, but only with respect to pre-2011 foreign taxes associated with the amount that is deductible for U.S. but not for foreign purposes, or which is deductible for foreign purposes but does not give rise to income for U.S. purposes.

(Notice 2010-92, Sec. 4.) The IRS and Treasury were, arguably, quite restrained in crafting such a narrow list of transactions.

How to Apply Section 909 to Foreign Taxes Not Exempted by the Notice

Pre-2011 foreign taxes not exempted by the notice (pre-2011 split taxes) will become subject to Section 909, for purposes of determining taxes deemed paid under Section 902 or 960 after 2010, starting with the Section 902 corporation's 2011 tax year. Such pre-2011 foreign taxes from foreign tax credit splitting events will be removed from the Section 902 corporation's foreign tax pools, starting with the corporation's first post-2010 year. These taxes will not be taken into account for U.S. tax purposes until the related income is taken into account by the Section 902 corporation that paid or accrued the taxes (payor Section 902 corporation) or by its Section 902 shareholder (with a special affiliated group rule, described below). However, "there is no increase to a Section 902 corporation's earnings and profits for the amount of any pre-2011 taxes to which Section 909 applies that were previously deducted in computing earnings and profits in a pre-2011 taxable year." (Notice 2011-92, Sec. 2.02.)

Suppose the taxpayer decides to avoid this result by causing pre-2011 split taxes to be deemed paid under Section 902 or 960 before the Section 902 corporation's 2011 year. The notice provides some general rules on how to pull up (cause to be deemed paid) pre-2011 split taxes. Foreign taxes deemed paid under Section 902 or 960 (or otherwise removed from foreign tax pools) in pre-2011 years are treated as coming pro rata from pre-2011 split taxes and other taxes (including pre-1997 taxes). (Notice 2010-92, Sec. 4.06(c)(1).) That means that causing X amount of pre-2011 split taxes to be deemed paid could require pulling up considerably more than X amount of aggregate foreign taxes. For example, assume that Section 902 corporation A has 100 of foreign taxes in its post-1986 tax pool for the general basket (which is its only basket), including 50 of pre-2011 split taxes. A dividend of 60 percent of A's post-1986 undistributed earnings pool pulls up 60 of foreign taxes, but only 30 of the pre-2011 split taxes. This pro rata rule is specific to taxes deemed paid before 2011, so it is possible that Treasury and the IRS could provide a different rule for foreign taxes deemed paid after 2010.

Causing X amount of pre-2011 split taxes to be deemed paid could require pulling up considerably more than X amount of aggregate foreign taxes.

Additional Rules for Applying Section 909 to Pre-2011 Split Taxes

Notice 2010-92 also sets forth additional rules for the application of section 909 to pre-2011 split taxes and related income. (Notice 2010-92, Sec. 4.06.) Among other things, these rules apply to determine whether related income has been taken into account by the payor Section 902 corporation or its section 902 shareholder (or an

affiliate) before the payor Section 902 corporation's 2011 tax year, which would be grounds for non-application of section 909 to the relevant taxes. (*See* Notice 2010-92, Sec. 3(c).)

The notice provides that distributions and inclusions out of earnings and profits of covered persons are treated as made pro rata from related income and other income (including pre-1997 income). (Notice 2010-92, Sec. 4.06(b)(3).) However, a Section 902 shareholder may elect to instead treat such distributions and inclusions as made first out of related income. This election can be made on a timely filed original tax return for the first post-2010 year in which the shareholder computes foreign taxes deemed paid with respect to a Section 902 corporation's pre-2011 split taxes. The method, if chosen, must be applied consistently for all pre-2011 splitter arrangements (the four types of transactions that can be treated as foreign tax credit-splitting events with respect to pre-2011 taxes under the notice).

Related income, other income, pre-2011 split taxes and other taxes, and the amounts distributed or deemed paid, must be determined for each taxable year of a Section 902 corporation, starting with the first post-1996 tax year for which it paid or accrued pre-2011 split tax and ending with its last pre-2011 tax year. (Notice 2010-92, Sec. 4.06(a).) Such annual amounts of related income and pre-2011 taxes with respect to the same pre-2011 splitter arrangement are aggregated. Annual and aggregate amounts of related income and pre-2011 split taxes are determined for each separate category (as defined in Treas. Reg. § 1.901-4(m), which basically describes Section 904(d) categories and other classifications that are treated as Section 904(d) categories), each covered person, and each other person that succeeds to such income or taxes. *(Id.)*

For each pre-2011 splitter arrangement, when related income is taken into account (by the payor Section 902 corporation or a Section 902 shareholder), a ratable portion of the foreign taxes associated with that arrangement loses its character as a pre-2011 split tax. (Notice 2010-92, Sec. 4.06(c)(4).) Thus, distribution or inclusion of related income affects section 909 deferral only for pre-2011 split taxes associated with that income, not for the pre-2011 split taxes associated with other transactions. The notice further provides that, for reverse hybrid and foreign consolidated group arrangements, if related income is reduced to zero or less, the associated pre-2011 split taxes retain their character as pre-2011 split taxes, and remain suspended under Section 909 until aggregate related income for the relevant arrangement becomes positive and is taken into account as Section 909 requires. *(Id.)* This limited rule raises a question, and a possible negative inference, about the treatment of pre-2011 split taxes associated with a loss sharing or hybrid instrument arrangement for which aggregate related income is reduced to zero or less.

Related income is considered taken into account by a Section 902 shareholder to the extent recognized as gross income (upon a distribution or inclusion out of earnings and profits of a covered person attributable to the related income) by *either* the shareholder or any member of an affiliated group (as defined in Section 1504) that files a consolidated return including the Section 902 shareholder. (Notice 2010-92, Sec. 4.06(b)(7), (b)(9).) This rule regarding income recognition by an affiliated group member is a relaxation of the statutory rule, which requires that the income be taken into account for U.S. tax purposes by the payor 902 corporation or a Section 902 shareholder of such corporation.

Four types of arrangements can cause pre-2011 foreign taxes to be suspended under Section 909.

Related income is treated as taken into account by a Section 902 corporation if either the income is included in the Section 902 corporation's earnings and profits by reason of a distribution or inclusion from the covered person's earnings and profits attributable to the related income, or the corporation and the covered person are combined under Section 381(a)(1) or (2). (Notice 2010-92, Sec. 4.06(b)(8).)

Content of Future Guidance

The rules for applying Section 909 to post-2010 taxes are still not certain. Notice 2010-92 clearly states that further guidance is expected, and that future rules for post-2010 taxes may not mirror the rules for pre-2011 taxes. (*See* Notice 2010-92, Sec. 1.)

But the notice does appear to be the IRS's definitive word on which transactions are treated as foreign tax credit splitting events for pre-2011 foreign taxes. (*See* Notice 2010-92, Sec. 1.) For example, if pre-2011 foreign taxes paid or accrued by Section 902 corporation X relate to a plain vanilla loss-sharing election that is not described in Notice 2010-92, then Section 909 does not apply to those taxes. Future guidance may apply Section 909's anti-deferral rule to additional loss-sharing fact patterns that are not described in the notice, including corporation X's loss sharing fact pattern. The notice appears to provide that Section 909 will still not apply to X's pre-2011 foreign taxes,

even after such hypothetical future guidance is issued. (*See* Notice 2010-92, Sec. 1.) However, X's post-2010 foreign taxes that relate to such later-described loss-sharing would be subject to Section 909, if so provided in a future guidance.

Notice 2010-92's rules on pulling up related income regarding pre-2011 splitter arrangements (including moving such income to the payor Section 902 corporation) and pre-2011 split taxes might not apply indefinitely to pre-2011 taxes, and might instead be changed in future guidance.[5] It is also possible that such rules will differ for post-2010 foreign taxes. For example, rules for distributions from earnings and profits containing both related income and other income may be different from the notice's rules: the notice requests comments on "ordering rules for dividends" in such situations. (Notice 2010-92, Sec. 8.)

Taxpayers must decide whether to pull up foreign taxes from Section 902 corporations before the end of such corporations' 2010 tax years, because taxes deemed paid or accrued under Section 902 or 960 before 2011 are not subject to Section 909.

Considerations for Whether to Pull Up Pre-2011 Taxes Before the End of 2010

For pre-2011 foreign taxes that are not "pre-2011 split taxes," i.e., that Notice 2011-92 treats as not connected with a splitter transaction (*see* Notice 2010-92, Sec. 4), Section 909 does not apply regardless of whether the foreign taxes are pulled up before or after the end of the 2010 tax year. (Notice 2010-92, Sec. 4.) If Notice 2010-92 exempts such pre-2011 taxes from Section 909, it does not appear that future guidance will change that result. (*See* Notice 2010-92, Sec. 1, *cf.* Notice 2010-92, Sec. 7 (effective date).) Therefore, causing such pre-2011 taxes to be deemed paid before 2011 provides no particular benefit with respect to Section 909's application, except that such taxes may need to be pulled up as part of an effort to bring up pre-2011 split taxes from the same tax pools.

For pre-2011 split taxes, the calculus is different. If those taxes are deemed paid before the Section 902 corporation's 2011 year, they are not subject to suspension under Section 909. But pulling the foreign taxes up essentially requires a dividend or Subpart F inclusion. Some fact patterns might require a sizable dividend or Subpart F inclusion (depending on the relative sizes of the earnings and profits and tax pools) to pull up a significant amount of pre-2011 split taxes, while for other taxpayers a relatively small income inclusion might result. Pre-2011 split taxes and other taxes are treated as pulled up pro rata, which potentially increases the amount of earnings and profits required to pull up the pre-2011 split taxes, and may require pulling up other taxes earlier than planned. Causing taxes to be deemed paid in 2010 also starts the 10-year carryforward period under Section 904(c).

In contrast, if pre-2011 split taxes are not deemed paid before 2011, then Section 909 does apply. As a result, pre-2011 split taxes are removed from the Section 902 corporation's tax pools in 2011. After 2010, to claim a credit for pre-2011 split taxes, related income must be taken into account by the payor Section 902 corporation or a Section 902 shareholder (or a member of its affiliated group that uses the same consolidated return). This may be sizable, depending on the taxpayer's facts. In addition, not only must the taxpayer identify the related income, but it often needs to move the related income from the covered person to the Section 902 corporation, section 902 shareholder, or affiliated corporation. In some cases this could be accomplished by a dividend, but in other cases it might be difficult, for example, if the covered person has no earnings and profits in a later year.

If Section 909 applies to such pre-2011 split taxes (because they are not deemed paid before 2011), then, at least as long as Notice 2010-92's rules continue to apply, the taxpayer needs to identify the related income for each splitter transaction and calculate related income, other income, pre-2011 split taxes, and other taxes for each year, starting with the Section 902 corporation's first post-1996 year in which it has a pre-2011 split tax and ending with its last pre-2011 year. (Notice 2010-92, Sec. 4.06(a)(1).) These calculations are made separately for each Section 904(d) "basket" and each covered person. (*Id*. Sec. 4.04(a)(2).) Thus, claiming a deemed paid credit for such taxes after 2010 is, among other things, potentially a much more complicated process than if the taxes are deemed paid before 2011.

Multiple factors can affect a taxpayer's decision of whether to pull up pre-2011 taxes of a Section 902 corporation before Section 909's effective date. For example, a taxpayer may consider the effective rate of the foreign taxes in a Section 902 corporation's tax pools, the size of the dividend or Subpart F inclusion that would be required to pull up the taxes, the relative

size of the related income, whether the taxpayer can use a foreign tax credit, and whether the taxpayer wants to delay starting the 10-year carryforward period for foreign taxes (which begins when the taxes are deemed paid).[6]

Summary/Conclusion

Taxpayers must decide whether to pull up foreign taxes from Section 902 corporations before the end of such corporations' 2010 tax years, because taxes deemed paid or accrued under Section 902(a) or 960 before such Section 902 corporations' 2011 tax years are not subject to Section 909. Notice 2010-92 provides important guidance to assist taxpayers in making this determination. In particular, it narrows the types of arrangements that are treated as foreign tax credit splitting events for pre-2010 taxes, and also exempts pre-1997 foreign taxes of Section 902 corporations from Section 909. Notice 2010-92 is very clear that rules for post-2010 taxes, in future guidance, may differ from the rules the notice provides for pre-2011 taxes. Stay tuned for the dropping of the next shoe.

[1]For purposes of Section 909, a Section 902 corporation means "any foreign corporation in which one or more domestic corporations meets the ownership requirements of subsection (a) or (b) of Section 902." Section 909(d)(5). The term therefore includes a controlled foreign corporation (CFC).

[2]For purposes of Notice 2010-92, "pre-2011 taxes" means foreign income taxes paid or accrued by a Section 902 corporation in its pre-2011 tax years. That term and "pre-2011 foreign taxes" are used interchangeably in this article.

[3]The notice explains that this exception for pre-1997 taxes is provided "because it is unlikely that material amounts of foreign income taxes described in that paragraph were accumulated and not previously deemed paid." Notice 201-92, Sec. 3.

[4]"… to the extent that the taxpayer did 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 included in the foreign tax base under the principles of § 1.901-2(f)(3)." Notice 2010-92, Sec. 4.03.

[5]*See* Notice 2010-92, Sec. 1 (creating a possible negative inference by stating that "future guidance . . . *relating to the definition of a foreign tax credit splitting event* will apply only with respect to foreign income taxes paid or accrued in post-2010 taxable years," *emphasis added*), Lee Sheppard, News Analysis: IRS Discusses Foreign Tax Credit Splitter Notice, 2010 Tax Notes Today 238-9 (December 13, 2010) (quoting Ronald Dabrowski, IRS Deputy Associate Chief Counsel (International), as stating that the election to pull up related income first might not be available in future years, and that the notice was intended to encourage taxpayers to move related income to the payor Section 902 corporation or its Section 902 shareholder, presumably because the rules relating to pre-2011 taxes might change in the future).

[6]*See* Section 904(c). ❑