New Foreign Tax Credit Anti-Splitting Rule

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In a foreign tax credit splitting event, newly enacted section 909 essentially defers FTCs until the related income is taken into account. Section 909's interpretation poses some challenges, especially in identifying the related income.

A. Introduction

On August 10 President Obama signed into law a bill containing several new foreign tax credit provisions. Perhaps the biggest change is a new rule requiring "matching" of foreign tax credits with the foreign income to which they relate, in the case of splitter transactions. Matching has long been a goal of the IRS and Treasury, for example in *Guardian Industries* (which the government lost) and the proposed legal liability regulations.[1] Those regulations generally provide that the person entitled to claim a credit for foreign taxes is the person who owns (under foreign tax law) the income that is subject to the foreign tax. In other words, matching.

The general theory behind matching (as a big-picture concept) is that the FTC is intended to reduce double taxation on foreign-source income, which is only achieved if the credit is given to the same person who recognizes the foreign-source income for U.S. tax purposes. But that theory has proven difficult to condense into administrable, mechanical rules, as evidenced by the long delay in finalizing the proposed legal liability regulations.

The new anti-splitting (or matching) rule of section 909 attempts to give the FTC (in the case of a splitter transaction) to the person who takes the related income into account for U.S. tax purposes, not foreign tax purposes. Determining which income is related to which foreign tax is likely to be a focus of Treasury guidance under the new rule and may be difficult. Also, although section 909 appears to address *Guardian* and certain other fact patterns, it is not clear how it applies to some other situations. Further, section 909 does not make the legal liability regulations unnecessary, but it is not entirely clear how the two will interact. Lastly, the new provision applies only when related parties are involved, although Treasury is given authority to provide otherwise.

B. The New Statutory Provision

New section 909 provides that:

> If there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by the taxpayer, such tax shall not be taken into account for purposes of this title before the taxable year in which the related income is taken into account under this chapter by the taxpayer.

Section 909(a). Thus, it requires that the related income be taken into account for U.S. tax purposes by the same taxpayer who paid or accrued the foreign taxes,[2] not merely that the income be recognized for U.S. purposes by any taxpayer, or even by any non-tax-exempt U.S. taxpayer. A foreign tax credit splitting event ("splitting event" or "splitter transaction") occurs when the income (or earnings and profits, for a section 902 or section 960 credit) associated with the foreign taxes is (or will be) taken into account for U.S. tax purposes by a person related to the foreign taxes' payer or by any other person specified by Treasury. In other words, a splitting event takes place when foreign taxes and the related income are allocated to different but related persons for U.S. tax purposes. The related person is technically called a "covered person," and is defined as including a person who directly or indirectly owns (or is owned by) the taxpayer to the extent of at least 10 percent of vote or value, or a person related to the taxpayer within the meaning of sections 267(b) or 707(b), or any other person specified by Treasury.

If a splitting event occurs in the case of a section 902 or section 960 credit, foreign taxes are not taken into account until the related income is taken into

[1]*See* prop. reg. section 1.901-2(f); *Guardian Industries v. United States*, 477 F.3d 1368 (Fed. Cir. 2007), *Doc 2007-4863*, *2007 TNT 38-14*.

[2]A slightly different rule, described below, applies for sections 902 and 960 credits.

account for U.S. tax purposes by the relevant section 902 corporation[3] (not a sister corporation, but the actual 902 corporation that paid or accrued the foreign taxes) or a domestic corporation qualified to claim a section 902 credit for that corporation's taxes.[4] For partnerships, section 909's rules are applied at the partner level.[5]

In the case of a splitter transaction, new section 909 attempts to place foreign taxes and their related income in the same tax year and with the same person for U.S. tax purposes, but the person is the key. If the same person has both the foreign taxes and the related income (and no covered person takes the income into account) for U.S. tax purposes, failure to take the income into account in the same year as the taxes for U.S. purposes does not delay the FTC under section 909. Different, related persons taking into account foreign taxes and related income is the trigger, and the outcome is a matching of both tax year and person.

If the foreign tax is not taken into account because of section 909, that tax is ignored for federal tax purposes until the tax year in which the related income is taken into account as required under that section, and it is treated as paid or accrued in that year.[6] Therefore, the deferred foreign taxes do not affect section 904(c) carryovers, section 6511(d)(3)(A) extended periods for claiming a credit or refund, or other calculations under the code until the year in which they are taken into account under section 909, nor can they be claimed as deductions before that year.[7] However, those deferred taxes will be translated into U.S. dollars under the rules of section 986(a) regardless of the year taken into account under section 909.[8]

For purposes of section 909, ''income taxes'' include both ''income, war profits, and excess profits taxes'' within the meaning of section 901 and in lieu taxes to which section 903 applies.[9] Section 909 applies to foreign taxes paid or accrued in tax years beginning after December 31, 2010. It also applies to foreign taxes paid or accrued by a section 902 corporation in any year (if not deemed paid before 2011), including those taxes paid or accrued before 2011, for purposes of determining taxes deemed paid under sections 902 or 960 in tax years beginning after December 31, 2010.[10] (However, section 909 does not apply to those pre-2011 taxes for purposes of determining a section 902 corporation's earnings and profits under sections 909(b)(2) and 964(a).) Thus, when section 909 takes effect in 2011, it will affect taxpayers' ability to claim credits for foreign taxes in the existing tax pools of section 902 corporations, even if the relevant foreign taxes were paid or accrued before its enactment. This makes it even more important to obtain relatively prompt guidance as to how to apply section 909. An IRS official has stated that the IRS and Treasury will attempt to issue preliminary guidance on section 909 in December 2010.[11]

The new statute gives Treasury authority to issue guidance, including regulations providing ''appropriate exceptions'' and those addressing the treatment of hybrid instruments.[12] The JCT explanation also states that ''it is anticipated'' that Treasury may issue guidance on section 909's application to group relief regimes, disregarded payments, or ''arrangements having a similar effect.''

C. Discussion

1. Focus on the person who takes income into account for U.S. purposes. In the case of a splitter transaction, the new rule attempts to give the FTC to the person who recognizes the related income for *U.S.* tax purposes, rather than the person who takes the income into account for *foreign* tax purposes.[13] That can make a big difference when the United States and the foreign country perceive different persons as recognizing the income. Some of those situations are illustrated in the examples to the proposed legal liability regulations.[14] The IRS has previously tried to match FTCs with the person treated as owning the income for *foreign* purposes,[15] and has declined to match credits to the person that U.S. tax law treats as recognizing the foreign-source

[3]A ''section 902 corporation'' is defined as a foreign corporation for which at least one domestic corporation meets the ownership requirements of section 902(a) or (b). *See* section 909(d)(5). This does not exactly duplicate the definition of a ''noncontrolled 902 corporation'' under section 904(d)(2)(E), because the latter contains a special rule for controlled foreign corporations.

[4]Section 909(b).

[5]Section 909(c)(1).

[6]Section 909(c)(2).

[7]*Id.*; Joint Committee on Taxation, ''Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representations on August 10, 2010,'' JCX-46-10 (JCT explanation) (Aug. 2010), *Doc 2010-17846*, *2010 TNT 154-16*.

[8]*Id.*

[9]Section 909(d)(2); P.L. 111-226, section 211(c); JCT explanation, *supra* note 7, at text accompanying note 21.

[10]P.L. 111-226, section 211(c).

[11]*See* comments of Barbara Felker, reported by Marie Sapirie, ''Early FTC Guidance Coming by Year's End, Officials Say,'' *Tax Notes*, Sept. 16, 2010, p. 1228, *Doc 2010-20211*, or *2010 TNT 179-1*.

[12]Section 909(e).

[13]The JCT explanation, *supra* note 7, confirms that interpretation.

[14]*See* prop. reg. section 1.901-2(f)(6).

[15]*See* current reg. section 1.901-2(f)(1); prop. reg. section 1.901-2(f)(1).

income. Section 909 therefore represents a major departure from the IRS's historical approach.

2. Identifying 'related income.' Related income is circularly defined in section 909 as the income to which the foreign taxes relate.[16] Different portions of a tax may have different related income.[17] Identifying related income is crucial, because a splitting event exists only if related income is taken into account for U.S. purposes by a covered person and (once section 909 applies) credits may not be claimed until the related income is taken into account by the taxpayer or the relevant 902 corporation. Determining the related income for any particular foreign tax also appears to be one of the more difficult tasks facing the IRS in interpreting the statute, as explained below.

Current regulations contain basic rules for associating foreign taxes with income. Those rules apply for purposes of allocating foreign taxes to ''baskets,'' and are cross-referenced by partnership regulations that attempt to match foreign tax expenses with the associated income.[18] But those regulations link foreign taxes to income based on *foreign* law's perception of the foreign tax base. Section 909, in contrast, aims to pair foreign taxes with income based on *U.S.* tax law.

Essentially, section 909 requires the following inquiry: When foreign tax is paid or accrued, which income perceived by the U.S. tax system[19] does the foreign tax relate to in the U.S. tax system's view? Thus, the foreign-law view of the foreign tax base is not determinative. The identification of related income may involve ignoring foreign-law elections to share losses; foreign perception of whether a payment is a dividend, interest, or return of capital; and foreign law's resulting view of which entity has income.[20] Although neither the statute nor the JCT explanation contains an explicit statement to that effect, the latter contains a relevant example.

In the example, an instrument issued by a subsidiary CFC to its parent CFC is treated as equity for U.S. purposes and as debt for foreign purposes. The foreign country taxes the parent CFC's accrued (but not yet received) interest income from the instrument, while U.S. tax law treats that amount as remaining with the subsidiary CFC. The example states that the ''related income'' for those foreign taxes is the E&P of the subsidiary CFC. Therefore, there is a splitter transaction. The example illustrates that foreign law's delineation of the foreign tax base does not determine related income under section 909. U.S. and foreign law, in the example, even perceive different types of income (active business income and interest, respectively) in the hands of different persons.

One could read the example as saying that neither CFC has any additional income, other than the amount ($100 in the example) treated as being received by the parent or retained by the subsidiary as E&P, respectively. That case is arguably easier, as far as tracing the foreign tax to the income in another entity, than if the parent and subsidiary both have multiple other items of income. If the parent CFC has income of $500 for foreign law purposes and $400 for U.S. purposes, it is a little more complicated to distinguish which part of a (for example) $50 tax is attributable to the $100 that the United States sees as E&P of the subsidiary. That situation requires some analysis of foreign law (for example, what items are included in the foreign tax base and whether different tax rates apply to different types of income), similar to the analysis under reg. section 1.904-6.

The task of tying foreign taxes to the relevant U.S.-perceived income resembles the existing challenge of timing differences, which require matching foreign taxes paid or accrued in one year with income recognized by the United States in a different year for purposes of ''basketing'' the income under section 904.[21] The timing difference rule provides that if foreign tax is imposed on an item that would be income under U.S. principles in a different year, the tax is basketed as if the income were recognized for U.S. purposes in the same year that the tax is imposed.[22] Practically speaking, this rule has also been applied to situations in which U.S. and foreign law perceive different types of income — for example where foreign law sees a dividend and U.S. law sees a circular cash flow or interest.[23] Timing difference questions have long presented thorny issues, which the IRS has never completely resolved. The difficulties stem partly from basic fact patterns such as the following: if a foreign subsidiary's distribution to its parent is taxed in the foreign country as a dividend, but is a return of capital for U.S. tax purposes, what past or

[16]Section 909(d)(3).

[17]*Id.*

[18]*See* reg. section 1.904-6; section 1.704-1(b)(4)(viii)(d)(1).

[19]The JCT explanation says that related income consists of income (or earnings and profits) ''calculated under U.S. tax principles.''

[20]*See* comments of José Murillo, reported by Lee A. Sheppard, ''Your Advanced Course in Pending Foreign Tax Credit Tighteners,'' *Tax Notes*, July 26, 2010, p. 349, *Doc 2010-16203*, or *2010 TNT 140-2*; JCT explanation, *supra* note 7.

[21]*See* reg. section 1.904-6(a)(1)(iv).

[22]*Id.*

[23]*See, e.g.*, FSA 200101005, *cf.* 1995 FSA Lexis 48.

future U.S.-perceived income can the taxes be associated with? What if the subsidiary never pays a future distribution that is perceived as a dividend for U.S. purposes?

The IRS's ruling practice has been to err on the side of associating a foreign tax with some type of income, rather than classifying it as a "base difference" in which the tax is associated with no income for U.S. purposes.[24] Although it has asked for comments in the past,[25] the IRS has not recently revised the timing difference regulation. It appears that the government will need to face similar issues for purposes of identifying which income is "related" to foreign taxes.[26]

The JCT explanation's hybrid instrument example, discussed above, arguably addresses a situation in which the income subjected to foreign tax is simply not present for U.S. tax purposes. The example associates the foreign taxes with other income, in another person's hands, that U.S. tax law does recognize. That implies that the IRS will trace the foreign taxes to some "related income" (in a different entity or in a different year, if necessary), even when the person subject to foreign tax has no income for U.S. purposes. That approach would be consistent with the IRS's historic position that there are very few actual "base differences" (situations in which foreign tax is imposed on an item that does not constitute income for U.S. purposes) and that timing differences (in which the foreign and U.S. tax systems perceive income in different years or, practically speaking, of different types) vastly predominate.[27] The IRS might take a similar approach to matching foreign taxes with "related income": It might argue that there is related income in almost every case, and that instances of foreign tax imposed where there is no income (in any entity, in any year) for U.S. purposes are very rare.

Once the related income is identified, taxpayers will need to determine when the related income is "taken into account" by the taxpayer. For example, in the hybrid example above, the lowest level CFC might continue to earn active income, accumulating a total of $500 of active E&P (in the U.S. view) by year 5. When it makes a distribution of $50 to its CFC parent in year 6, how much of that distribution is attributable to the $100 of "related income" already accumulated by the end of year 1 (the year in which the CFC parent paid the foreign tax that was deferred under section 909)? The IRS has said that this determination may require rules or conventions that could include stacking, a pro rata concept, or other solutions.[28]

3. Scope. Section 909 applies only when there is an FTC splitting event, as defined therein. It does not provide a general rule that FTCs are available only to taxpayers who recognize the related income for U.S. tax purposes.

It does appear to address the *Guardian*[29] fact pattern. In general terms, that's a situation in which a U.S. parent owns a foreign holding company, which owns one or more foreign operating entities. The foreign holding company is treated as a disregarded entity under the check-the-box rules, but it and the operating companies are taxed as a group under foreign law with (let's assume for this analysis) legal liability placed on the foreign holding company for foreign tax purposes. Under section 909, the U.S. parent would be unable to claim a section 901 credit for the group's taxes (on the operating companies' income) until the U.S. parent took that income into account for U.S. tax purposes. There would be a splitting event because covered persons — the operating companies — take the related income into account for U.S. tax purposes. In an alternate fact pattern in which the holding company does not become a disregarded entity, the U.S. parent would not be able to claim a section 902 credit for the group's taxes until either the U.S. parent or the holding company took the related income (the operating companies' income) into account for U.S. tax purposes. Section 909 similarly appears to apply to the fact pattern described in CCA 200920051,[30] in which the U.S. tax rules perceive the related income to be held at the lowest tier while legal liability belongs to higher level entities.

Further, officials have strongly hinted that Treasury and the IRS are likely to treat loss sharing (for example, under U.K. tax rules) as creating a splitting event under section 909, at least in some situations.[31] One typical loss sharing fact pattern might be as follows: Surrender Co. and Receiving

[24]*See, e.g.*, FSA 200101005, 1997 FSA Lexis 186, *cf.* T.D. 8805, 1991-1 C.B. 371, 374 ("Treasury and the Service believe that a base difference exists within the meaning of section 1.904-6(a)(1)(iv) only when a foreign country taxes items that the United States would never treat as taxable income."), compare FSA 200210026 (use of base difference rule was "not unreasonable").

[25]*See* T.D. 8916, 2001-1 C.B. 360, 364 (Preamble).

[26]The JCT explanation also states that the IRS may provide rules relating to timing differences between U.S. and foreign law. JCT explanation, *supra* note 7, at text accompanying note 21.

[27]*See, e.g.*, T.D. 8916, Preamble, *supra* note 25; FSA 200101005, *Doc 2001-755*, *2001 TNT 5-66*.

[28]*See supra* note 11.

[29]*See Guardian Industries v. United States*, 477 F.3d 1368 (Fed. Cir. 2007).

[30]*Doc 2009-11181*, *2009 TNT 93-60*.

[31]*See* comments of Murillo, *supra* note 20; comments of Manal Corwin, reported by Randall Jackson, "U.S. Perception of Related Income Needs to Be Clarified, Practitioners Say," *Tax Notes*, Oct. 4, 2010, p. 59, *Doc 2010-20989*, or *2010 TNT 186-6*.

Co. are sister U.K. corporations that are wholly owned by Foreign Parent Co., which is owned by U.S. Parent Co. In year 1, Surrender Co. has a net loss while Receiving Co. has income. Surrender Co. elects to surrender its loss to Receiving Co., which uses the loss to reduce its income from 100 to 10 for U.K. tax purposes. Receiving Co. pays U.K. tax on 10 of income. In year 2, Surrender Co. has income of 100 for U.K. purposes, and pays U.K. tax on that 100 of income. Surrender Co. is likely to have little or no income in year 2 for U.S. tax purposes, if the previous year's loss surrender is disregarded under U.S. tax principles (because U.S. law treats the loss as available to offset income in year 2). The question is which income is ''related'' to the foreign taxes paid by Surrender Co. in year 2. If this loss sharing fact pattern is a foreign tax credit splitting event under section 909, then Surrender Co.'s year 2 U.K. taxes are likely not to be creditable until Surrender Co., or a U.S. person eligible for a 902 or 960 credit from Surrender Co., takes the related income (possibly future income of Surrender Co.) into account for U.S. tax purposes.[32] At least one official has also said, however, that Treasury may consider an exception for some group relief situations.[33]

The JCT explanation states that, ''It is anticipated that the Secretary may also provide guidance as to the proper application of the provision in cases involving . . . group relief, and other arrangements having a similar effect.'' One could argue about whether that statement implies that section 909 is not self-executing regarding group relief. A Treasury official has stated that section 909 does indeed apply to group relief fact patterns when it takes effect, even before guidance is issued.[34] One huge issue regarding group relief and other fact patterns concerns how exactly taxpayers are to apply section 909 if the ''related income'' is not easily and obviously identifiable, and how taxpayers can achieve adequate certainty that they have correctly determined the related income.

Section 909 does not apply if there is no ''related income'' for U.S. purposes. A no-income situation does not technically generate a splitter event because there is no related income for a covered person to take into account. But taxpayers may find it challenging to reach a sufficient level of confidence, in any given fact pattern, that there is no related income.[35] It is not clear what the answer will be, for example, for payments from disregarded entities, and the JCT explanation says that ''it is anticipated that the Secretary may also provide guidance'' regarding disregarded payments.

Another fact pattern yields a similar result under section 909: if there is identifiable related income, but no person is required to take the income into account under chapter 1 of the code, section 909 does not technically apply because there is no splitting event. A splitting event is created by a covered party's taking related income into account under chapter 1, not by the U.S. taxpayer's (or section 902 corporation's) failure to take the income into account. If U.S. tax law views the related income as belonging to a foreign, non-902 corporation counterparty that is not engaged in a U.S. trade or business, section 909 does not appear to apply. (If the counterparty is a U.S. tax-exempt entity, in contrast, it seems likely that it would be viewed as ''taking the income into account'' under U.S. tax law, even if it is not taxable on the income.) Several of the examples in the proposed legal liability regulations set forth fact patterns that could make use of non-902 corporation foreign counterparties.[36] The proposed regulations do not provide an appealing (from a policy perspective) solution that achieves matching for all of these fact patterns, and (apparently) neither does section 909.

The JCT explanation states that a splitting event does not occur in two situations. First, there is no splitting event if a CFC pays foreign taxes on income that it takes into account for U.S. tax purposes in the same year, even if the related earnings and profits are taken into account by a covered person as a dividend or a subpart F inclusion.[37] (The literal language of the statute appears to treat that situation as a splitting event, but does not defer credits in that case because the section 902 corporation has taken the related income into account.) Secondly, Congress did not intend there to be a splitting event by reason of ''differences in the timing of when income is taken into account for U.S. and foreign tax purposes,'' if the same person pays foreign taxes and takes the related income into account for U.S. tax purposes in different years.[38] If a timing difference exists but a covered person also

[32]The proposed legal liability regulations are a little more lenient in that respect: they provide that loss sharing does not trigger the combined income rule. Prop. reg. section 901-2(f)(2)(ii)(A).

[33]*See* comments of Murillo, *supra* note 20.

[34]*See* comments of Corwin, *supra* note 31.

[35]It is also not obvious what the policy reason was for excluding no-related-income situations from section 909, given that there is arguably no double taxation if a foreign country imposes tax and the United States does not tax the same or a related item.

[36]*See* prop. reg. section 1.901-2(f).

[37]*See* JCT explanation, *supra* note 7, at note 21.

[38]*See* JCT explanation, *supra* note 7.

takes the income into account, then presumably deferral might apply under section 909.

4. Interaction with the legal liability regulations. Section 909's interaction with the existing and proposed legal liability regulations[39] is not entirely clear, given the somewhat conflicting rules in the new statute and the regulations. The legal liability regulations provide that "the person by whom tax is considered paid for purposes of section 901 and 903 is the person on whom foreign law imposes legal liability for such tax. [That] person is referred to as the 'taxpayer.'"[40] The proposed regulations state (in a clarification or change, depending on who one talks to) that the person with legal liability under foreign law, for these purposes, is the person required to take the income into account under foreign law (or the owner of the income, in the case of a section 903 "in lieu" tax).[41] The new anti-splitting rule requires that the "taxpayer" who paid or accrued the foreign tax must take the related income into account under chapter 1 of the U.S. tax code to be eligible to claim an FTC, if there is a splitting event.[42]

The JCT explanation's discussion of the matching rule does not mention the current or proposed regulations, and does not state whether the matching rule was intended to replace the current (or proposed) regulations or to impose an additional requirement. It is not clear whether or how the IRS will amend the legal liability regulations to coordinate with section 909. The IRS could potentially change the regulations to adopt section 909's concept of following the U.S. tax law's perception of which person recognizes the foreign-source income instead of (rather than in addition to) the regulations' approach of examining which person has legal liability for the tax (and, under the proposed regulations, who owns the income) under foreign law.

If either the current regulations continue in force or the proposed regulations are finalized (possibly in some truncated form)[43] after section 909 takes effect, the only persons eligible to claim an FTC with respect to a splitting event will be those who both have legal liability under foreign law and also take the related income into account under U.S. tax law. If the proposed regulations were finalized, the FTC would require that the "taxpayer" in a splitter transaction take income into account for both foreign (under the proposed regulations) and U.S. (per section 909) tax purposes, although the related income under section 909 is not necessarily the same as the relevant income under the proposed regulations. If FTCs were restricted (at least when related parties are involved in credit splitting) to taxpayers who take the associated income into account for both foreign and U.S. purposes, that would certainly seem consistent with the FTC's purpose of reducing double taxation.

Section 909 does not make the legal liability rules irrelevant or redundant. In the absence of the legal liability rule, there would be no affirmative rule identifying the person who is eligible to claim a credit. Section 909 does not provide an affirmative designation, but is phrased in the negative, as a bar to claiming the credit until the "taxpayer" (not defined in that provision) takes the income into account. Therefore, the new anti-splitting rule and the legal liability regulations are not completely overlapping. Section 909 is a narrower antiabuse rule, while the legal liability rules provide (among other things) basic rules for ordinary business transactions.

The antiabuse effect of the proposed legal liability regulations' combined income rule, including its application to reverse hybrid entities, is probably unnecessary after section 909 takes effect, except when there is no income for U.S. tax purposes. Where foreign law imposes tax on the combined income of two or more persons, the combined income rule allocates tax liability pro rata based on each person's share of the income, determined under *foreign* law, with some modifications.[44] This rule also applies where a reverse hybrid's owner is required to take the reverse hybrid's income into account for foreign tax purposes. The current regulations take a similar approach in cases of joint and several liability for foreign tax on combined income of related persons, allocating legal liability for those taxes pro rata based on each person's "portion of the base of the tax."[45] When the combined income, or joint and several liability, rules allocate legal liability to a foreign corporation, the U.S. taxpayer essentially must wait for a dividend or subpart F inclusion before claiming a credit for the foreign taxes. Section 909's application to those fact patterns reaches a similar overall result, but requires that the "related income" in particular must be taken into account. An affirmative mechanical rule

[39]Reg. section 1.901-2(f), also called the technical taxpayer rule.

[40]Reg. section 1.901-2(f)(1).

[41]Prop. reg. section 1.901-2(f)(1)(i) and (ii).

[42]Section 909(a).

[43]*See* comments by Murillo, reported in Sheppard, "Your Cheat Sheet for Foreign Tax Credit Tighteners," *Tax Notes*, July 19, 2010, p. 248, *Doc 2010-15622*, or *2010 TNT 135-5* (citing Murillo as stating that parts of the proposed regulations could be "salvaged and adapted").

[44]Prop. reg. section 1.901-2(f)(2)(i) and (iv).

[45]Reg. section 1.901-2(f)(3).

to allocate legal liability (or some other criteria for eligibility to claim a credit) in those fact patterns is still needed, even after section 909 takes effect, so even the combined income rule has not become irrelevant.

Section 909(a) and the legal liability regulations contain some overlapping terminology. Very similar phrasing regarding ''tak[ing] into account'' income is used in the proposed regulations' definition of legal liability[46] and in the new provision. Also, both refer to a ''taxpayer'' who ''pays'' the foreign tax, although section 909 does not define those terms. Instead, another part of section 909 (in the definition of covered person) defines ''any person who pays or accrues a foreign income tax'' as the ''payor,'' rather than using the regulatory term ''taxpayer.'' So it is not obvious whether the statute intended to incorporate the regulations' definition of the person who pays or accrues foreign tax (the taxpayer, in those regulations) as meaning the person who has legal liability under foreign law.

5. Interaction with other regulations. Section 909 appears to address some but not all of the situations covered by the proposed compulsory payment group rule, which treats a U.S.-owned foreign group, connected by at least 80 percent ownership, as one taxpayer for purposes of the compulsory payment rule.[47] That rule currently applies at the taxpayer's election.[48] Section 909 is likely to apply (according to Treasury statements) to loss-sharing situations also addressed by the proposed group rule. Thus, some loss sharing situations that do not result in denial of FTCs under the compulsory payment rule (after application of the proposed regulations) could nonetheless result in deferral of credits under section 909. However, section 909 may not affect other fact patterns impacted by the group rule, such as foreign-law settlements of the tax liabilities of multiple related parties. Section 909's enactment may or may not affect the likelihood that the proposed compulsory payment regulation will be finalized.

Further, section 909 was apparently intended to apply in addition to existing regulations that address allocation of foreign tax expenditures among partners.[49] With respect to a partnership, sections 909(a) (the basic rule on foreign tax credit splitting events and 901 taxes) and 909(b) (the rule on sections 902 and 960 taxes) apply at the partner level.[50] That presumably means that whether another person is a ''covered person'' is determined with respect to the partner that would otherwise take the foreign taxes into account for U.S. purposes (that is, the partner treated as paying or accruing the foreign taxes). For example, assume that partnership A is a hybrid, taxed in country Z as a corporation. A's two partners are P1 (a U.S. person) and P2, which is itself a partnership of partners X and Y. If A pays a foreign tax that is allocated to P1, but the ''related income'' is taken into account for U.S. purposes by X, the question under section 909 appears to be whether X is a covered person with respect to P1, not whether X is a covered person with respect to A (which is more likely).

The regulations addressing partnerships' allocation of foreign tax credits could theoretically allow such a fact pattern. Those regulations provide a safe harbor that essentially requires matching the percentages of foreign taxes and foreign income in each CFTE (creditable foreign tax expenditure) category for each partner, rather than matching of foreign taxes with specific items of related income.[51] However, it's not clear that a fact pattern yielding allowable credits under the partnership regulations but deferred taxes under section 909 is actually abusive, from a policy perspective. In the example above, applying the safe harbor in the partnership regulations in effect would require that P1 be allocated a share of income from A, in the same CFTE category as and proportionate to the foreign taxes allocated to P1 from A. If section 909 applies (which depends on whether X is a covered person for P1), then P1 appears unable to claim a section 901 credit for the foreign taxes unless and until it takes the related income into account, which seems unlikely barring additional facts.

6. Limitation of 'covered person' to related persons. The new anti-splitting rule is technically limited to situations in which the foreign taxes and related income are allocated to different but related persons.[52] Although section 909's relationship threshold is quite low (for example, a 10 percent ownership interest is sufficient), there remains a loophole for situations that are structured to give the foreign taxes and related income to unrelated persons. For instance, several of the examples in the proposed legal liability regulations set forth fact patterns that could involve either unrelated or related parties.[53] However, the statute gives Treasury authority to expand the rule beyond related

[46]Prop. reg. section 1.901-2(f)(1)(i).
[47]Prop. reg. section 1.901-2(e)(5)(iii).
[48]Notice 2007-95, 2007-2 C.B. 1091, *Doc 2007-25747*, *2007 TNT 224-5*.
[49]*See* reg. 1.704-1(b)(4)(viii).
[50]Section 909(c)(1).
[51]*See* reg. section 1.704-1(b)(4)(viii).
[52]*See* section 909(d)(4).
[53]Prop. reg. section 1.901-2(f)(6).

persons, to any person that Treasury specifies.[54] Therefore, guidance could considerably broaden the scope of the transactions covered by the new anti-splitting rule. Theoretically, Treasury could cross-reference the section 482 regulations' concept of controlled taxpayers, which includes "control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose."[55] The JCT explanation states that Treasury "may issue regulations that treat an unrelated counterparty as a covered person in certain sale-repurchase transactions and certain other transactions deemed abusive," but there is no limitation in the statute on who may be treated as a covered person under Treasury guidance.

D. Summary

The new anti-splitting rule applies to taxes paid or accrued (or deemed paid or accrued under sections 902 or 960) in tax years beginning after December 31, 2010. That means that many splitter transactions that divided the FTC and related foreign-source income between two related parties (related by at least 10 percent ownership, or related within the meaning of sections 267(b) or 707(b)) will no longer result in a current FTC. Section 909 defers the credits until the associated income is "taken into account" by "the taxpayer," rather than actually disallowing the credits permanently. Defining which income is related to which particular foreign taxes will likely be a key component of IRS guidance, and may pose some challenges. Treasury and the IRS may also issue rules expanding section 909's regime to transactions involving unrelated parties.

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[54]Section 909(d)(4)(D).

[55]Reg. section 1.482-1(i)(4).