Splitting Events and the Indirect Foreign Tax Credit: A Practical Guide

By

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When foreign earnings are repatriated to the United States the accompanying indirect foreign tax credit is maximized when the ratio of the distributing corporation's post-1986 tax pool to its post-1986 earnings and profits has been made as large as possible.[1] In pursuit of this result, for years domestic corporations have arranged their overseas affairs so as to accumulate foreign E&P's in one subsidiary and the associated paid or accrued foreign income taxes in another. A variety of organizational structures exist that achieve this splitting result, among them reverse hybrids, loss-sharing arrangements, foreign consolidated group tax returns, and hybrid debt and equity instruments.[2]

Seeking to end that practice, effective August 10, 2010, Congress enacted 26 U.S.C. §909, which declared that when calculating the indirect foreign tax credit no foreign income taxes arising from a "splitting event" can be included until such time as their "related income" has been taken into account.[3] In addition, those same split taxes must be excluded when determining the foreign subsidiary's earnings and profits.[4]

Although these two new rules significantly impact certain aspects of current tax practice, specific examples illustrating their application are for the most part absent from the recently finalized regulations accompanying §909. So for now it's a little like trying to learn basketball by reading the rulebook instead of watching a game. The alternative? Let's assemble the players, blow the whistle, and set things in motion. By doing so we'll see how these splitter arrangements work, what §909 does to them, and identify some potential pitfalls to avoid going forward.

I. The Game

A. How To Score

Income earned abroad by U.S. citizens and resident aliens is taxable in the United States.[5] Unfortunately, as a rule it's also taxed in the foreign jurisdiction and so to avoid double taxation when income is repatriated a credit is allowed against the resulting U.S. taxes for the foreign taxes already paid or accrued. There are actually two types of foreign tax credits, one for taxes directly paid by the taxpayer to the foreign jurisdiction, and the other for those indirectly paid, often by a lower tier subsidiary on earnings eventually passed up the chain to the U.S. parent corporation.[6] Splitter arrangements concern themselves primarily with the latter kind.[7]

As formulated in I.R.C. §902, the indirect tax credit (up to the maximum allowed) equals the foreign corporation's post-1986 tax pool multiplied by the ratio of the foreign earnings repatriated to all post-1986 earnings and profits.[8] Viewed this way, the amount of paid or accrued foreign income tax available for credit against U.S. taxes is a percent of total E&P's repatriated.[9] For example, a dividend equal to half the total foreign E&P's entitles its domestic parent to a credit for half of the foreign taxes paid. Repatriating all the overseas earnings allows the U.S. parent a credit for all the foreign taxes paid.[10]

By this notion repatriating none of the foreign earnings and profits should mean that there can be no indirect foreign tax credit. Prior to enactment of §909, however, this was not necessarily the case. Instead, splitter arrangements have operated to allow a reduction of U.S. taxes for paid or accrued foreign tax even though the related foreign income had not been recognized. The result was a reduction of U.S. taxes imposed on other income which, given the time value of money, was a very good result indeed for anyone content to leave his foreign earnings abroad.[11]

An alternate but equivalent formulation of the §902 indirect tax credit can be more useful for planning purposes. In this view the order of the terms is reversed so that the credit equals the repatriated amount times the ratio of the tax pool to the earnings and profits pool. While the arithmetic leads to the same result as the statutory formulation (i.e., 3 times 4 divided by 2 gives the same result as 4 times 3 divided by 2) this reformulation better informs the notions behind the operation of foreign tax credit splitting events.

In particular, note that as the tax to E&P pool ratio increases so does the portion of the repatriated income that can be claimed as a credit against U.S. taxes. Moreover, the absolute size of the pools is irrelevant. It is only the ratio of the two that matters. To see this, imagine a controlled foreign corporation ("CFC")[12] pays its U.S. parent a dividend of $1000. If the distributing CFC has one billion dollars in its tax pool and two billion in its earnings and profits pool the §902 credit will be $500 ($1000 times 1 billion divided by 2 billion). The tax pool to E&P pool ratio is one-half.

But if that same CFC pays the same $1000 dividend and has only 900 dollars in its tax pool and 1200 dollars of accumulated E&P's (a ratio of three-quarters) the recipient's §902 tax credit will be $750, an increase of fifty percent. And that is why splitter arrangements have been so popular.

B. The Players

Foreign tax splitter arrangements allow financial managers to direct the flow of paid or accrued foreign taxes into one subsidiary's tax pool while sending the related income to a different subsidiary's E&P pool. By doing so the key ratio is maximized in the "tax pool" subsidiary and therefore so is the §902 tax credit accompanying any repatriation it makes. We'll see how all this works in the examples below but first take a look at how §909 and its regulations define the participants in a foreign tax splitting arrangement.

A good place to start is by identifying the "Payor" who, as might be expected, is the entity on whom liability for the foreign tax is imposed.[13] Related to the payor are "Covered Persons", a term including both the entities that own ten percent or more of the payor, and those in which the payor owns at least a ten percent share.[14] Next comes the "902 corporation", which is actually a foreign corporation with income from which a U.S. corporation's §902 tax credit could arise.[15] And finally there is the "902 shareholder", typically the U.S. parent of a 902 corporation.[16]

Note that while a payor can never be a covered person it can be a 902 corporation. By its terms §909 applies only to "foreign tax credit splitting events" and those occur whenever the income related to a paid or accrued foreign tax is "taken into account…by a covered person"[17], i.e., someone other than the payor. The term "related income", not surprisingly, just refers to the foreign income (or earnings and profits) from which the foreign taxes arose.[18] Thus, in a splitting event the Payor's tax pool increases while its E&P pool has no corresponding increase. The result? The ratio of the two pools is larger than it should be and that, after all, is the whole point of a foreign tax splitting arrangement.

C. The Anti-Splitter Rules

Section 909 is meant to prevent taxpayers from being able to claim a tax credit for foreign taxes paid or accrued before the related income has been repatriated. So rule number one has to be: Where there has been a foreign tax credit splitting event those foreign taxes must be excluded from the payor's tax pool.[19] Doing that much restores the payor's tax pool to what it would have been before the splitting event.

But that's only half the job done. The paid or accrued foreign taxes were deducted from the payor's income when calculating its new E&P pool balance. Only suspending the split tax from the payor's tax pool would leave the ratio of the two out of balance. Rule number two, therefore, has to be: Calculation of earnings and profits cannot include a reduction for any suspended taxes.[20]

These first two rules unwind the foreign tax credit splitting event's effect on the payor but they leave the suspended foreign taxes waiting for release. And so we need two more rules. Rule three: The suspended tax can only be released into its tax pool, and the associated earnings and profits added to its E&P pool, when the related income has been "taken into account." And rule four: Related income is deemed to have been taken into account when it has been paid from the earnings and profits of a covered person to either a 902 corporation or a 902 shareholder.[21]

When the temporary §909 regulations were first issued they contained an exclusive list of arrangements which could give rise to a foreign tax credit splitting event: the reverse hybrid, loss sharing arrangements, foreign consolidated group tax returns, and both hybrid debt and hybrid equity instruments.[22] The examples that follow are drawn from this list. In the final regulations, however, issued just a few months later that exclusive list had become merely illustrative: "This notice states that future guidance will provide that foreign tax credit splitting events in post-2010 taxable years *will at least include* all of the pre-2011 splitter arrangements."[23]

On a going-forward basis, therefore, taxpayers wishing to claim §902 tax credits will need remain alert for situations which might inadvertently be characterized as splitting events and so subject them unexpectedly to §909's foreign tax suspension regime. A good way to develop that awareness is to study the application of §909 to the currently known income-splitting devices, i.e., the pre-2011 listing given by Notice 2010-92. Here, the old advice remains wise: Follow the money.

II. The Cases

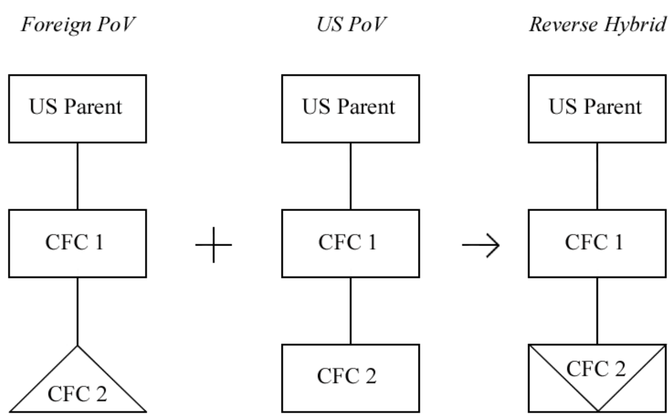
So as to better focus on the operation of each splitting event, in these examples the following simplifying assumptions will be made. First, all E&P and tax pools are assumed to have already been adjusted as needed for splitter-related income and taxes from 1977 to the beginning of the current year.[24] Second, no additional withholding or foreign taxes are imposed as a result of any distributions made. Third, none of the earnings discussed here are subject to subpart F deemed distributions. Fourth, all foreign subsidiaries are considered to have been wholly owned by their U.S. parents throughout the taxable period under consideration.

And with that we are ready to begin.

A. Reverse Hybrids

1. How They Work

Perhaps the most common of the tax and income splitting devices, the reverse hybrid CFC became popular following the advent of the check-the-box regulations.[25] The structure below is typical. Note that the two subsidiaries need not be domiciled in the same foreign country but that the lowest one (CFC2) must be both a pass-through entity under local law and an "eligible entity" for purposes of the check-the-box regulations.[26] That is, to become a reverse hybrid CFC2 must check the box and elect to be taxed by the United States as a corporation. In symbols the resulting structure looks like this:

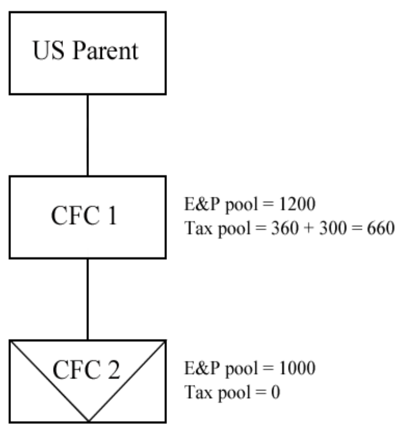


This structure gives rise to a splitting event because of the "technical taxpayer rule", which states that the foreign income tax is deemed paid by the entity on which the foreign jurisdiction imposes legal liability for it.[27] That is, foreign taxes paid or accrued on foreign income are added to the tax pool of the entity bearing the legal liability for them. Here, that's CFC1 since the foreign jurisdiction sees CFC2 as only a pass-through. On the other hand, for U.S. tax purposes CFC2 is a separate, corporate entity and so its earnings and profits are all its own, and are therefore added to its own E&P pool.

To see this in motion suppose that CFC1 and CFC2 both began life in the current year, with CFC1's earnings and profits for the year totaling 1200, after 360 in paid foreign income tax. CFC2's E&P's for the year were 1000, after 300 in associated foreign income taxes. Because

CFC2 is seen as a pass-through by the foreign jurisdiction, however, it is actually CFC1 that bears responsibility for all the foreign tax and so (as the "technical taxpayer") its tax pool now equals 660. CFC2 is not liable for any foreign income tax at all and accordingly its tax pool remains at zero.

Earnings and profits, however, are a different matter. From the U.S. point of view CFC2 by election is a separate entity, not a pass through, and so its earnings are its own. Thus, CFC2 now has 1000 in its earnings and profits pool while CFC1's E&P pool equals 1200. As can be seen in the diagram below the 300 of foreign income tax has been completely split from the 1000 of earnings and profits related to it:



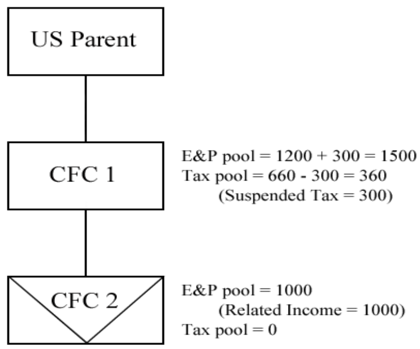
Now suppose that the US Parent ("USP") elects to repatriate 750 of its foreign earnings. As one option, USP could choose to have CFC1 pay it a dividend from CFC1's own earnings and profits. On the other hand, it could choose to have CFC2 pass the dividend up to CFC1, which would in turn pass it on to USP. As we shall see, the tax consequences to USP differ materially between these two choices.

2. Calculating the §902 Tax Credit

As shown above, use of the reverse hybrid structure has added 300 to CFC1's tax pool that actually arose from income earned by CFC2, giving CFC1 a tax to E&P pool ratio of .55 (i.e., 660 divided by 1200). Before the advent of §909, had CFC1 paid USP the 750 dividend from its own E&P pool USP would have received a §902 tax credit equal to 412 (i.e., the dividend amount times the tax to E&P pool ratio of .55). Without that 300 boost, CFC1's tax pool would have included only the 360 it paid on its own 1200 of earnings, giving a ratio of .30 (i.e., 360 divided by 1200) and a far smaller §902 tax credit of 225. It is precisely this tax credit inflation that has made reverse hybrids so useful to taxpayers and which §909 was enacted to prevent.

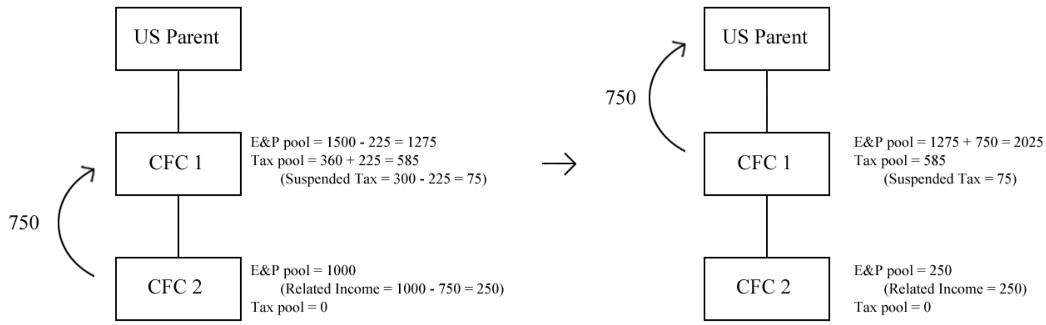
Because the reverse hybrid structure is now an explicitly recognized foreign tax credit splitting device[28] the foreign taxes paid or accrued in connection with it cannot be "taken into account" for §902 tax credit purposes "before the taxable year in which the related income is taken into account…by the taxpayer."[29] To determine when this occurs we must translate our situation into §909 terms.

The "split taxes" in this situation are "the foreign income taxes paid or accrued with respect to income of the reverse hybrid" and the "related income" is the reverse hybrid's income that gave rise to those split foreign taxes.[30] Thus, CFC1 presently has 300 of split tax in its tax pool, and CFC2 (the reverse hybrid) has 1000 of related income in its earnings and profits pool. Pursuant to §909, then, the 300 of split taxes must be suspended from CFC1's tax pool. In addition, because earnings and profits are net of taxes, absent an exception[31] suspension of the split tax requires that an equal amount be added back to CFC1's earnings and profits pool.[32] The following diagram summarizes the post-§909 situation:



USP will only receive a §902 credit for the paid but suspended foreign tax when the related income has been "taken into account", that is, only when it has been paid by a "covered person" (i.e., CFC2)[33] to a §902 corporation or shareholder (i.e., either USP or CFC1).[34]

In this case, the 1000 of related income, presently tucked away in CFC2's earnings and profits pool, can be taken into account in two ways. First, if CFC2 (as a "covered person") were to pay a 750 dividend to CFC1 (a 902 corporation) then three-quarters of the 1000 of related income held by CFC2 would have been "taken into account",[35] in this case by explicitly reuniting the split taxes and related income. Accordingly, three-quarters of CFC1's suspended taxes (i.e., 225 of 300) would be released into its tax pool, and a corresponding downward adjustment (for 225 of foreign taxes now recognized as paid) made to its earnings and profits pool. The 750 dividend received by CFC1 also adds to its E&P pool[36]:



Now when CFC1 passes on the 750 dividend to USP, the U.S. tax on that income will be offset by a §902 credit equal to 217 (i.e., 750 times 585 divided by 2025). The 75 of suspended tax still held by CFC1 awaits a future distribution by CFC2 of its remaining 250 of related income.

In the alternative, USP could elect to receive its 750 dividend directly from CFC1, leaving the related income in CFC2 untouched. Because CFC1 is the payor, however, by definition it cannot be a covered person. And since related income is only taken into account when received on distribution from a covered person, CFC1's dividend would release none of its suspended taxes. As a result, the §902 credit allowed USP on that distribution would be just 180 (the 750 dividend times the post-suspense tax pool of 360 divided by the 1500 of corresponding, adjusted earnings and profits). Apart from giving a noticeably smaller §902 tax credit, this option has released none of the suspended taxes and so USP's future §902 credits are also materially impacted.[37]

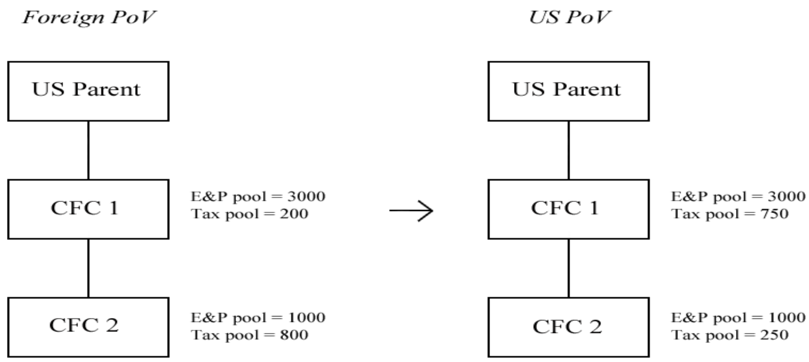
In summary, prior to §909 the reverse hybrid would have operated to allow USP to take into account foreign taxes paid on income earned by CFC2 prior to repatriating its earnings and profits. As a result, a §902 tax credit of 412 would have been allowed. After enactment of the anti-splitter rules, however, that effect is undone and the allowed credit reduced to a maximum of 217, a reduction of more than 47 percent. Also, in the post-§909 world USP must be aware that its choice of source for a current repatriation can impact future allowed credits by releasing (or failing to release) any of the now suspended taxes.

B. Foreign Consolidated Groups

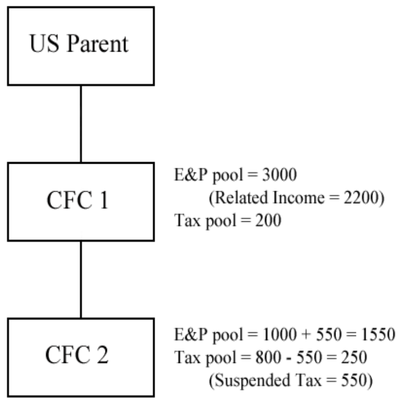
1. How They Work

For §909 purposes a foreign consolidated group exists when "a foreign country imposes tax on the combined income of two or more entities."[38] In the case of grouped income, for tax purposes the United States supposes that the foreign income tax has been imposed on members of the group in proportion to the members' underlying earnings.[39] The foreign jurisdiction's rules, however, may differ.[40] As a result, a splitting of paid or accrued foreign tax from its related income can occur.

Consider again our two-tier structure but this time let's suppose there are no hybrid elements. Assume the subsidiaries began operations in the current tax year and that both are domiciled in the same foreign jurisdiction where they incur income tax. Together CFC1 and CFC2 have 4000 in consolidated earnings and profits (3000 and 1000, respectively), net of 1000 in paid foreign income taxes. Pursuant to the foreign jurisdiction's consolidation rules, and the U.S. proportional allocation rules[41], the foreign taxes have been assigned by each jurisdiction as follows:



The 550 difference between CFC2's foreign tax payment and the corresponding U.S. proportional allocation represents split taxes and must be suspended from CFC2's tax pool until such time as the related income is taken into account.[42] Because earnings and profits are net of foreign tax paid, and 550 of that tax is now suspended, CFC2 must also adjust upward its E&P pool by a corresponding amount.[43] If we assume an effective tax rate in the foreign jurisdiction is 25% then the income related to the 550 in suspended foreign income tax equals 2200 (i.e., 550 divided by .25), which as the figure above indicates, presently resides with CFC1. The following figure summarizes the beginning tax and E&P pool adjustments required:



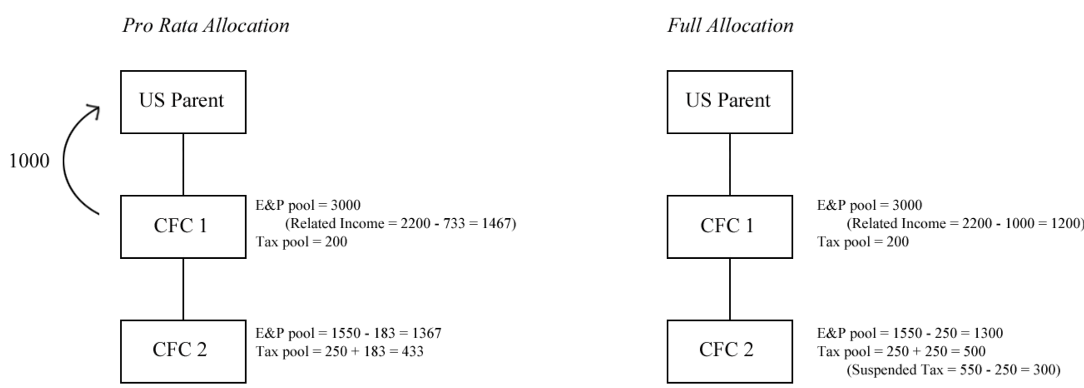
Note that CFC2, having actually paid that 550 of foreign tax is the payor here[44] while CFC1 and USP are covered persons. CFC1 and CFC2 are also 902 corporations while USP is a 902 shareholder. With that settled, USP now elects to repatriate 1000 of its foreign earnings.

2. Calculating the §902 Tax Credit

Before calculating the §902 credit, first note that here the related income resides with CFC1 while the suspended taxes belong to CFC2, the opposite of the reverse hybrid situation. In addition, while in the prior example all of the reverse hybrid's earnings and profits consisted entirely of related income, now CFC1's E&P pool is a mixture of those arising from the 2200 of related income and another 800 of unrelated earnings and profits. In this situation, §909 allows CFC1 the option to deem any distribution it makes to be comprised entirely of related income (up to the 2200 limit) or, in the alternative, as a pro rata mixture of the related and unrelated income.[45] To see the impact of these differences, consider what happens when USP chooses to receive its 1000 in repatriated income as a dividend from CFC1.

Under the pro rata option, this 1000 payment is 73% comprised of related income (i.e., 2200 of related income divided by 3000 of total earnings and profits), or 733, and the remaining 267 is from income unrelated to the splitting event. The 733 of related income taken into account by USP is 33.3% of all the related income (733 divided by 2200) and so its distribution releases that same percentage of suspended taxes, i.e., 183 (equaling .333 times 550).

In the alternative, under the full election option the entire 1000 is deemed paid from related income (equaling 45.5% of all related income, or 1000 divided by 2200) and so 45.5% of the suspended taxes (equaling 250 of the 550 total) are released. Under either option, however, note that while the related income is being distributed up to USP from middle-tier CFC1, its tax pool is unaffected because the suspended taxes reside with lower-tier CFC2. The following summarizes both cases:

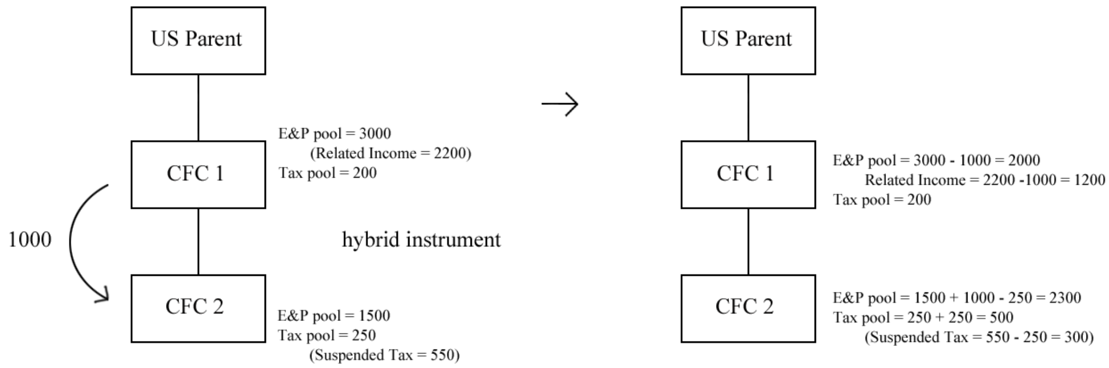


Surprisingly, in this case USP's §902 tax credit is the same regardless of the method chosen, and equals the 1000 dividend times the 200 tax pool and divided by the 3000 of earnings and profits, or 67. This occurs because the released suspended taxes are all in CFC2's tax pool and the corresponding E&P adjustment is therefore made only to CFC2's E&P pool. Both of

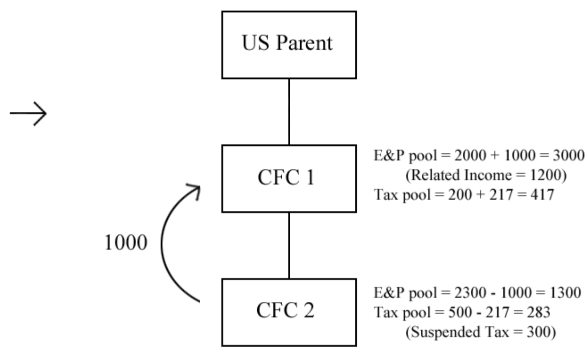
CFC1's pools are unchanged, with only an acknowledgement that some related income has been "taken into account". On the upside, CFC2's tax to E&P pool ratio has increased as a result of CFC1's distribution but that gain will only be realized on a different, future distribution by CFC2.

Equally dismaying, note that had CFC2 first paid a 1000 dividend to CFC1 (in anticipation of its being passed along to USP) none of CFC2's suspended taxes would have been released. CFC2 is, after all, the payor and so by definition cannot be a covered person.[46] Because related income is taken into account only on distribution by a covered person to either a 902 corporation or a 902 shareholder, no earnings that CFC2 ever distributes will release its suspended taxes.[47] Worse still, on receipt of CFC2's 1000 distribution CFC1's tax to E&P ratio would actually decline, giving USP an even smaller §902 tax credit on final repatriation.[48]

Recall, however, that while the payor CFC2 can never be a covered person it is, by definition, a §902 corporation. Therefore, USP could in principle release CFC2's suspended foreign tax by having CFC1 (as a covered person) distribute to CFC2 a portion of CFC1's related income: "Related income shall be considered taken into account…upon distribution…out of the earnings and profits of the covered person attributable to such income."[49] Therefore, on receipt of the 1000, under the full election a total of 250 in suspended taxes would be released into CFC2's tax pool. CFC2 could then distribute the 1000 back to CFC1 (along with an accompanying gross-up of 217, i.e., 1000 times 500 divided by 2300). The following figure shows the pools just after CFC1's distribution and CFC2's distribution back:



Applying §909



While this process might arguably have some administrative cost, it will result in a larger §902 tax credit for USP. That is, now when CFC1 dividends the 1000 on to USP the accompanying §902 credit is 139 (i.e., the 1000 dividend times CFC1's 417 tax pool and divided by its 3000 E&P pool). The remaining 300 in CFC2's suspended taxes awaits CFC1's distribution of its remaining 1200 of related income.

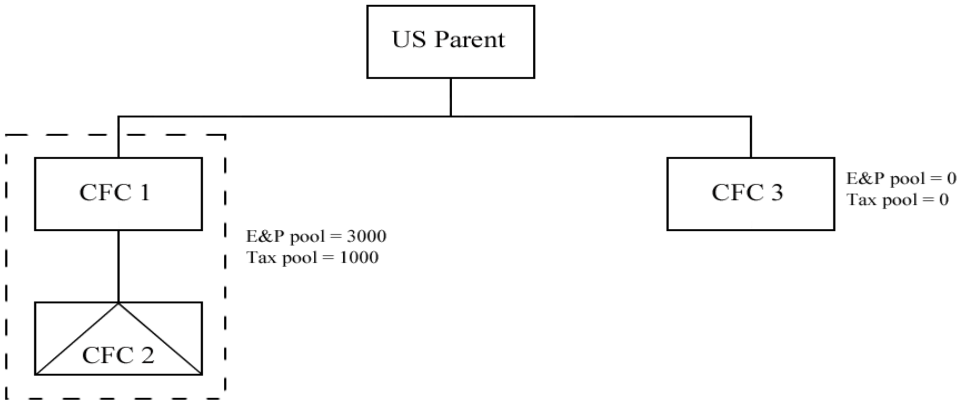
The series of steps given above plainly achieve §909's ostensible goal of reuniting foreign taxes with the split, related income. They also, however, invoke the step transaction doctrine, are undertaken only to gain a tax advantage, and as such completely lack either economic substance and legitimate, non-tax business purpose.[50] Only time will tell whether in the case of a splitting event achieving §909's new goal will overrule those long-established judicial doctrines. That the resulting §902 tax credit allowed is made larger by these steps, albeit still less than it would have been prior to enactment of §909, suggests that on audit the road to acceptance may be difficult.

C. The Loss Sharing Arrangement

1. How It Works

Under the final §909 regulations any loss-sharing arrangement is now deemed a "splitter arrangement" if the group giving up the loss could have actually used that loss to offset its own income but instead transferred it "to offset the income of another U.S. combined income group".[51] The figure below is based on one of the finalized regulations' only two examples. Here, a U.S. parent corporation wholly owns foreign subsidiary CFC1, which in turn wholly owns CFC2. Both are domiciled in country X where all income is taxed at 30 percent. Country X also views CFC2 as a separate entity from CFC1.[52] Under U.S. rules, however, CFC2 has elected to be considered a disregarded entity.[53] Because for U.S. tax purposes CFC1 and CFC2 combine their income, gains, losses, and deductions, they comprise a single "U.S. combined income group".[54]

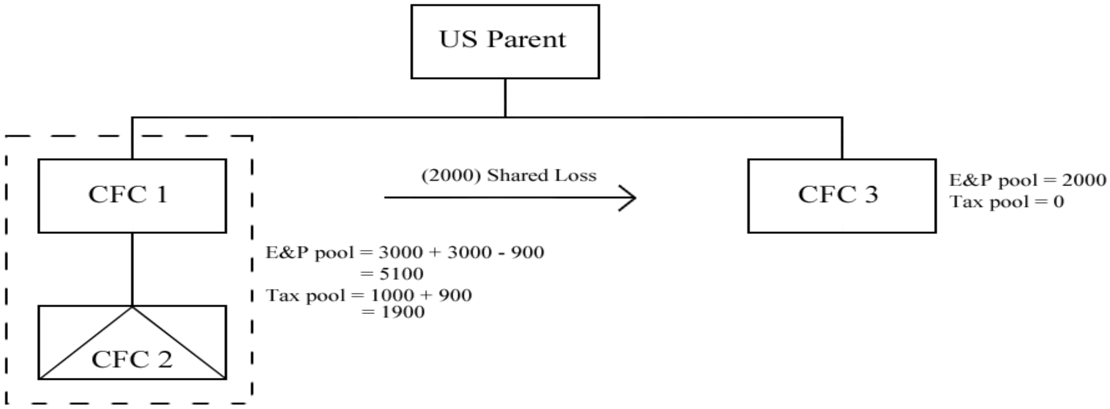
Suppose that prior to the current year, the CFC1-CFC2 group has accumulated earnings and profits of 3000 and a tax pool of 1000. At the beginning of the current year USP creates a new subsidiary, CFC3, also domiciled in country X:



Note that CFC3 comprises its own U.S. combined income group.[55]

Suppose further that CFC3 immediately enters into a local jurisdiction loss sharing regime with CFC1-CFC2.[56] Thereafter, during the current year, CFC1 experiences a loss of 2000, CFC2 a gain of 3000, and CFC3 a 2000 gain. Per the loss-sharing agreement for local jurisdiction tax purposes CFC1's 2000 loss is transferred to CFC3. As a result, CFC1's country X taxable income on the year is 0 while CFC2 retains its 3000 of income, and so country X imposes income taxes on CFC1 and CFC2 of 0 and 900 (30% of 0 and 3000), respectively. CFC3 offsets its 2000 of income with CFC1's loss and pays no country X taxes.

On the other hand, CFC1-CFC2 now has accumulated E&P's of 5100 (its prior accumulated 3000 plus the current year gain of 3000 less 900 in paid foreign tax) and a tax pool of 1900 (the prior 1000 plus the current year's 900). The following figure summarizes the end of current year results:



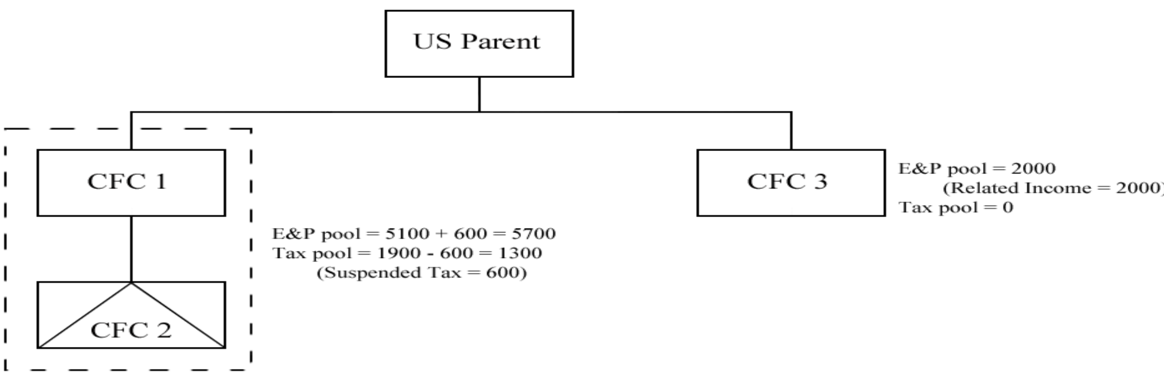
As can be seen, CFC3 has earnings and profits of 2000 but no associated tax.[57] The 600 in foreign income tax arising from CFC3's 2000 in earnings (at the 30% rate) has been separated and transferred to CFC1-CFC2. There has, therefore, been a §909 splitting event.

USP now elects to repatriate 1000 of its foreign earnings.

2. Calculating the §902 Tax Credit

The 2000 loss incurred by CFC2 and transferred to CFC3 under this loss-sharing regime constitutes a "shared loss".[58] Because that transferred loss could have been used instead to offset the CFC1-CFC2 combined income it is a "useable shared loss" and so transferring it to CFC3 gave rise to a "loss-sharing splitter arrangement."[59] The "split taxes" are those that would have been paid on income equal in amount to the transferred usable loss.[60] Finally, "related income" is the amount of gain actually offset by transferring the usable loss outside the combined income group.[61]

In this example, then, the useable loss is the entire 2000 transferred from CFC1-CFC2. Since the country X tax rate is 30%, there are 600 in split taxes residing with the CFC1-CFC2 group. And because the entire useable loss was actually used to offset CFC3's gain there is 2000 in related income, currently residing with CFC3. Per §909, the split taxes must be suspended from the CFC1-CFC2 tax pool and its E&P pool adjusted upward by a corresponding amount. Prior to any repatriation, the situation looks like this:



Here the CFC1-CFC2 group is the payor while only USP is a covered person. CFC1-CFC2 and CFC3 are both 902 corporations while USP is a 902 shareholder. Having sorted this, USP is now ready to decide how best to repatriate 1000 of its foreign earnings.

For example, USP could elect to receive its 1000 as a dividend from the CFC1-CFC2 group. In this case the accompanying §902 credit would equal 228 (1000 times 1300 divided by 5700). Because the CFC1-CFC2 group is the payor, however, it cannot be a covered person and so none of its paid dividend constitutes a taking into account of related income. Accordingly, none of the 600 in suspended taxes can be released into the CFC1-CFC2 group's tax pool for use with later distributions.

Taking the 1000 distribution from CFC3, however, has its own problem. Because CFC3's tax pool is empty any distribution from it to USP will result in a §902 tax credit equal to zero. On the other hand, paying half the related income to USP (a §902 shareholder), releases a corresponding amount of suspended taxes (half of the 600, or 300) into the CFC1-CFC2 tax pool, with its E&P pool adjusted downward by the same amount. This at least would pave the way for a later, more advantageous distribution by the CFC1-CFC2.

Finally, a strategy similar to that discussed above for Consolidated Groups could be undertaken. In particular, USP could first reunite the related income with the split taxes by having CFC3 (as a covered person) make a payment directly to CFC1-CFC2 (as a payoff §902 corporation). The suspended split taxes would then be released into the CFC1-CFC2 tax pool and a §902 credit allowed on them following repatriation of 1000 from CFC1-CFC2 to USP.

As was the case with foreign consolidated groups, however, this process also invokes step and sham transaction doctrine concerns.[62] Whether that distinction weakens the argument in favor of allowing such a process when it plainly achieves §909's goal in spite of long established judicial doctrine cannot now be known.

D. Hybrid Instruments

1. How They Work

Hybrid securities combine features of debt and equity, a common example being the convertible bond. While that instrument pays its holder regular interest (a debt feature) it also contains an option to "purchase" an equity interest in the bond's issuer by exchanging the instrument for shares of its stock. Although such instruments are in fact neither debt nor equity, for tax purposes, both domestically and abroad, hybrid instruments must be classified as entirely one or the other. When the foreign and U.S. jurisdictions disagree as that classification a foreign tax splitting event can occur.

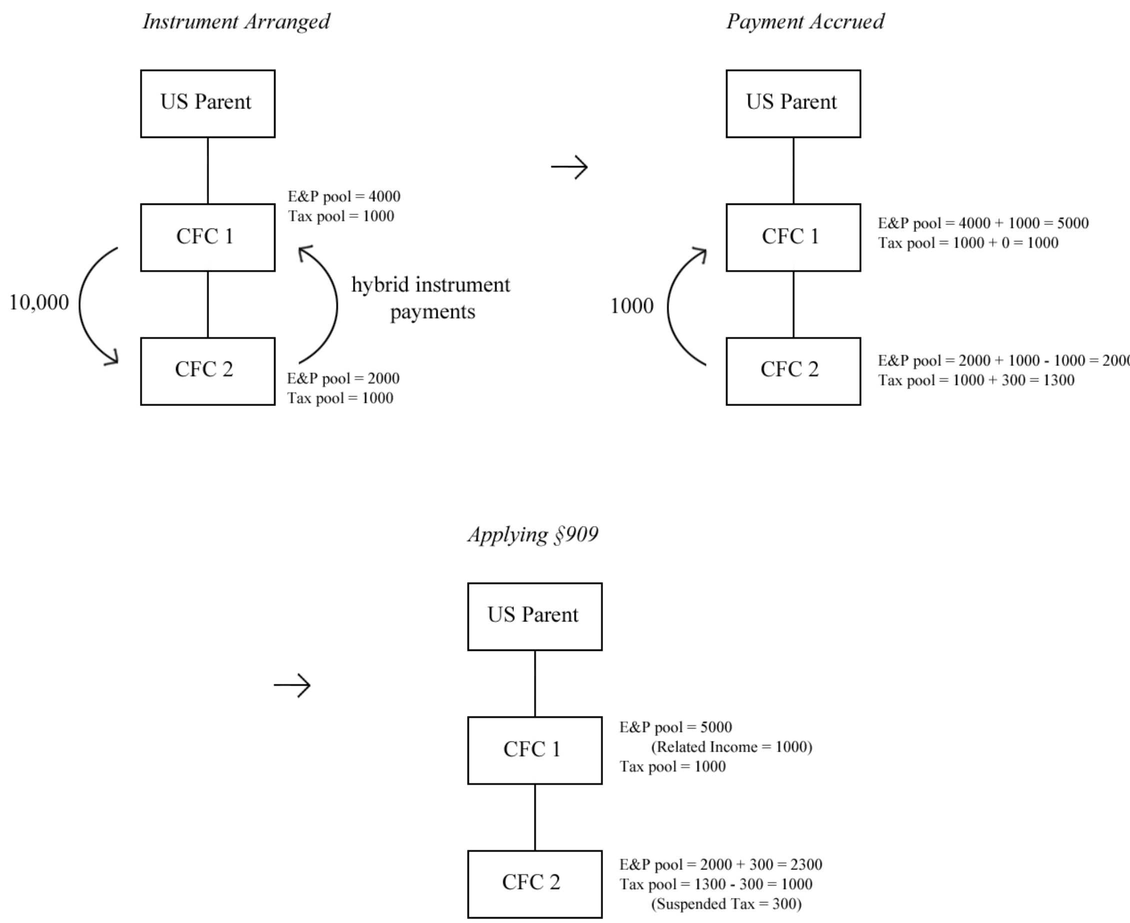
For example, if the U.S. classifies a given financial instrument as debt then the accrued payments on it are deemed interest income and as such add to the recipient's earnings and profits. But if the foreign jurisdiction sees the same instrument as equity then it will assess its local taxes on the issuing entity's investment earnings. In this situation the instrument is called a "debt hybrid instrument." If the roles were reversed, it would be an "equity hybrid instrument".

Returning to our USP and its two tier, foreign subsidiary arrangement, suppose that CFC1 purchases for 10,000 a hybrid instrument from CFC2, which promises annual 10% interest-like payments of 1000 in addition to other equity-like features. Suppose further that CFC2 profitably invests that 10,000 and thereby earns 1000 of annual income.

a. The Hybrid Debt Splitting Event

In this case, although the U.S. sees the hybrid instrument as debt the foreign jurisdiction sees an equity investment made by CFC1 in CFC2. The foreign jurisdiction, therefore, imposes (at an assumed 30% rate) 300 of income tax on CFC2's investment earnings and classifies the annual payments made by CFC2 to CFC1 as dividends (on which, by simplifying assumption, no tax is imposed).[63] The United States, on the other hand, seeing the hybrid instrument as debt treats the annual payments to CFC1 as interest income. Thus, each 1000 paid increases CFC1's earnings and profits pool, with a corresponding decrease to CFC2's E&P pool.

Consequently, CFC2 is the payor of the 300 in foreign income tax while CFC1 is the recipient of 1000 of related income.[64] Suppose that prior to this transaction CFC1 has accumulated tax and E&P pools of 1000 and 4000, respectively, while for CFC2 they are 1000 and 2000. The following diagram summarizes this transaction:



Note that CFC2's earnings and profits have once again been adjusted upward for the split taxes now suspended. USP now decides to repatriate 1000 of its foreign earnings.

With the split taxes and related income identified, and the appropriate pools adjusted for §909, we are now ready to calculate the indirect tax credit associated with each of the various repatriation options. But looking once again at the final step in the figure above, notice that the related income occupies the middle tier (CFC1) while the suspended taxes are all with the bottom tier (CFC2). In addition, CFC2 is the payor while CFC1 is a covered person.

This arrangement is, therefore, identical to the foreign consolidated group case previously discussed. Accordingly, the analysis and calculation of associated §902 credits need not be repeated here.

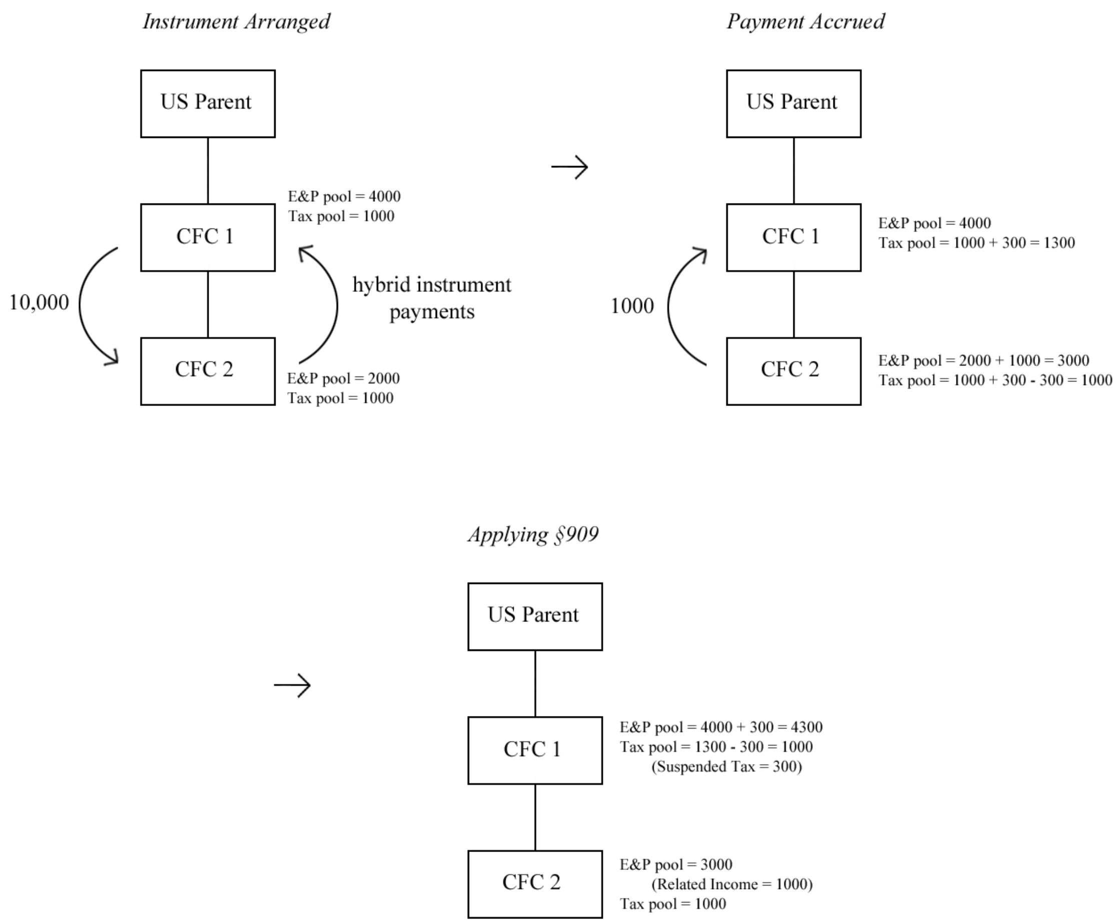
b. The Hybrid Equity Splitting Event

Here the financial instrument is the same as above but now it's seen for U.S. tax purposes as an equity investment while the foreign jurisdiction classifies it as debt. As before, CFC2 earns 1000 by investing the 10,000 received from CFC1. But this time suppose that CFC2 does not make its 1000 payment to CFC1, which the U.S. would see as a dividend, until after the close the tax year. In that situation, then, CFC2's end of year earnings and profits total 3000 while CFC1's E&P pool stands unchanged at 4000.

The foreign jurisdiction, however, seeing the hybrid instrument as a loan requires that the 1000 interest payment be recognized as accrued, whether or not it was actually paid. Thus, the foreign jurisdiction allows CFC2 a deduction of 1000 for interest paid, exactly offsetting its 1000 of investment earnings and resulting in zero foreign income tax owed. On the other hand CFC1 must recognize the 1000 for foreign tax purposes as interest income and therefore is assessed 300 (again at the assumed 30% rate) of income tax, which it adds to its tax pool.

As the figure below shows, there has been a split of the 300 in foreign income tax (now residing in CFC1's tax pool) from the 1000 of related income held by CFC2. Applying §909 we see that CFC1 is the payor of 300 in foreign tax while CFC2 holds the 1000 of related income.[65]

Pursuant to §909, then, the split taxes must be suspended. The figure below summarizes these results:



Comparing this with the hybrid debt situation discussed above we see the positions of the related income and the split taxes have been reversed. Now the suspended taxes reside with payor CFC1 and the related income with covered person CFC2. This trapping of related income in the bottom tier and the suspended foreign tax in the middle tier mirrors that of the Reverse Hybrid splitter arrangement with which we began. Since the calculation of the §902 credit will proceed in exactly the same way here as there that analysis will not be repeated.

Conclusion

The various cases explored here indicate that §909 will likely achieve its goal of eliminating the advantages of foreign tax splitting arrangements. In doing so, however, §909 introduces new complexity and significant uncertainty. In particular, in cases such as foreign consolidated groups and loss-sharing arrangements, the goal of reuniting suspended split tax with its related income may well require a sequence of interconnected distributions. It is unclear, however, whether that series of payments will be given independent effect on audit or appeal, or instead will be either disregarded or combined under the judicial step or sham transaction doctrines.

At the same time qualifying U.S. shareholders seeking to avail themselves of the §902 tax credit now have new administrative burdens to bear. First, both related income and suspended taxes must be identified, located, measured, and tracked. Second, adjustments will be required in the tax and E&P pools of each affected foreign subsidiary, on both a current and ongoing basis. For many, historical adjustments are required as well, all the way back to 1997.

Moreover, because the list of recognized splitter arrangements is no longer exclusive it is possible that, even without conscious intent, foreign tax credit splitting events might occur simply because of the way earnings materialize over the course of a tax year, or as a consequence of shifting notions as to what is debt or equity. Imagine, for example, that when a hybrid instrument is purchased both the U.S. and the foreign jurisdiction view it as equity. Years pass and later the U.S. determines the instrument should be viewed as debt. Immediately an income splitting event has occurred, quite possibly with retroactive ramifications.

Certainly, every potential restructuring should now include consideration as to whether, and in what circumstances, foreign taxes might be split from related income. That planning should also incorporate a reevaluation of whether the currently employed tax-splitting business structures, which may have served so well these past years, remain appropriate going forward. That is, given all the attendant burdens and audit risks, in a §909 world companies should now consider whether structures such as the reverse hybrid are the most efficient method of carrying on their business.

Finally, given that many are facing an era in which indirect tax credits will be smaller than anticipated while compliance risks are increased, the need to plan and manage those credits is greater than ever. As in many of the cases discussed here, a choice may have to be made between taking an immediate §902 credit or instead using a current distribution to free up suspended taxes in preparation for a later repatriation of foreign earnings. Since these choices impact considerations such as capital requirements and the time value of money, even more than in the past they should be integrated into overall corporate planning.

While the future is in many ways unclear, one thing is certain. The §909 anti-splitter rules will have a material impact on the future of international tax planning as it concerns the indirect foreign tax credit. Although the advantage of established splitting structures is for now diminished the new complexity they introduce should inevitably create new opportunities. The game, to borrow from a famous Londoner, is still afoot.

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[1] I.R.C. §902(a), (b)(to qualify for the credit the domestic parent must own at least ten percent of the voting stock of the distributing foreign corporation).
[2] Treas. Reg. 1.909-2T(b) (on February 14, 2012, the temporary regulations issued December 6, 2010 were finalized). *See also* I.R.S. Notice 2010-92 (December 7, 2010) at §4.01-4.05.
[3] I.R.C. §909(a), (b)(1).
[4] I.R.C. §909(b)(2). See also I.R.C. §964(a).
[5] *See, e.g., Cook v. Tait*, 265 U.S. 47 (1924).
[6] *See* I.R.C. §§901, 902. To claim the indirect foreign tax credit the U.S. taxpayer must be a corporation which owns at least ten percent of the dividend paying foreign corporation's voting stock. I.R.C. §902(a).
[7] An exploration of their use with the direct tax credit is saved for another day.
[8] I.R.C. §902(a), (b).

[9] Repatriation can be achieved in a variety of ways, including direct dividend, a deemed dividend per subpart F, investment in U.S. property, the liquidation of subsidiary, the sale of stock, and cash repatriations. See I.R.C. §§902(a), 951, 956(a), 367(b), 304, 331, 1248.

[10] The total credit allowed, however, cannot exceed the total, current U.S. taxes imposed times the foreign source income as a percent of total income. *See* I.R.C. §904(a). This calculation is further broken out by income type (i.e., "basket"). *See* Treas. Reg. 1.861-8; I.R.S. Form 1118. None-the-less, any excess foreign tax credit may be carried back one year or forward ten years. See I.R.C. §904(c), Treas. Reg. 1.904-2(a).

[11] In theory, the associated foreign income would give rise to U.S. tax when it is finally repatriated. But as repatriation is not actually required that could be a very long time coming. In the meantime, the taxpayer is free to invest his deferral and earn real returns.

[12] A controlled foreign corporation is any foreign corporation in which "U.S. shareholders" hold a greater than fifty percent interest in either the total voting power of all classes of stock or the total value of the stock at any time during the tax year. I.R.C. §957(a). A U.S. shareholder here is defined to mean any U.S. citizen or resident alien, domestic partnership or corporation owning ten percent or more of the total combined voting power of all classes of stock in the foreign corporation. I.R.C. §§951(b), 7701(a)(30). In the examples presented here all subsidiaries of a U.S. parent will be assumed to be controlled foreign corporations.

[13] Treas. Reg. 1.909-1T(a)(3). *See also* Treas. Reg. 1.901-2(f).

[14] I.R.C. §909(d)(4); *see also* Treas. Reg. 1.909-1T(a)(3). Note that the payor cannot, by definition, be a covered person. This definition also includes those directly or indirectly related pursuant to I.R.C. §§267(b) and 707(b).

[15] I.R.C. §909(d)(5); Treas. Reg. 1.909-1T(a)(1)(a 902 corporation is any corporation meeting the ownership requirements for the §902 indirect tax credit).

[16] Treas. Reg. 1.909-1T(a)(2)(a 902 shareholder is a domestic corporation that owns at least ten percent of a 902 corporation).

[17] I.R.C. §909(a), (d)(1).

[18] I.R.C. §909(d)(3).

[19] *See* I.R.C. §909(b)(1); Treas. Reg. 1.909-6T(d)(7), (8).

[20] I.R.C. §909(b)(2), (c)(2); s*ee also* Treas. Reg. 1.909-6T(d)(3), (4).

[21] Treas. Reg. 1.909-6T(d)(7), (d)(8). Note that distributions made from previously taxed income are not considered to have been made from related income. *See* Treas. Reg. 1.909-6T(d)(10).

[22]I.R.S. Notice 2010-92 (December 7, 2010), §§4.01-4.05. *See also Treas. Reg.* 1.909-6T(b). For many §902 claimants, the structures listed had been in place long before §909's 1997 effective date. In such a case, if by the end of the 2011 tax year the §902 credit had already been claimed then suspension of the splitter-related foreign taxes and related E&P adjustments were not required. *See* I.R.S. Notice 2010-92 (December 7, 2010) at 4.06(a)(4), (5) and 4.06(c)(1), (4); *Treas. Reg.* 1.909-6T(c)(3), (4). Otherwise, accounting for excluded splitter-event income and taxes, beginning with post-1996 tax years is mandated, with adjustments made annually thereafter. I.R.S. Notice 2010-92 (December 7, 2010) at §4.06(a). *See also Treas. Reg.* 1.909-6T(c). Although the 1997 beginning date is unexplained it does correspond to enactment of the "check-the-box" entity classification regulations which gave rise to the reverse hybrid structures, themselves most well-known for their use in creating foreign tax credit splitting events. Note also that failure to claim the §902 credit prior to the effective date meant that any advantage accumulated since 1997 was entirely lost.

[23] Treas. Dept. 9577, 77 FR 8127-01 (Feb. 14, 2012), §II (emphasis supplied).

[24] Treas. Reg. 1.909-6T(c).

[25] Treas. Reg. 301.7701-3(a)(for U.S. tax purposes whether an entity is separate from its owners is a matter of U.S. federal law and does not depend on local law classification). S*ee also* I.R.S. Form 8832.

[26] Treas. Reg. 301.7701-2(b)(8)(*per se* corporations list); Treas. Reg. 301.7701-3(a)(eligible entities).

[27] Treas. Reg. 1.901-2(f)(1). As stated in both the temporary and final regulations, however, the question as to which entity in a reverse hybrid structure is deemed to have paid the foreign tax is now under review. *See* Treas. Dept. 9576 (Feb. 14, 2012), Background, §II; I.R.S. Notice 2010-92 (December 7, 2010), §2.03.
[28] Treas. Reg. 1.909-2T(b)(1).
[29] I.R.C. §909(a).
[30] Treas. Reg. 1.909-2T(b)(1)(ii), (iii).
[31] *See, e.g.*, I.R.C. §964(b)(blocked foreign income need not be included in earnings and profits).
[32] I.R.C. §909(b)(2). Because CFC2 is charged with paying no foreign tax its earnings and profits were not previously adjusted downward for them. Accordingly, the upward adjustment must made to the technical taxpayer's E&P pool.
[33] I.R.C. §909(d)(4)(A), (B).

[34] I.R.C. §909(d)(5); Treas. Reg. 1.909-1T(a)(1), (2).
[35] Treas. Reg. 1.909-6T(d)(8).
[36] Recall that, for simplicity's sake, we are assuming here no additional withholding or other taxes are imposed on dividend payments.
[37] For completeness, consider that USP could also elect to receive its dividend directly from CFC2, thereby "hopscotching" over CFC1. While subject to another new rule limiting §902 credit options, the "anti-hopscotch" rule (*see* I.R.C. §956(c)), in this case the allowed credit would equal zero since CFC2's tax to E&P pool ratio in zero.
[38] Treas. Reg. 1.909-6T(b)(2). The foreign jurisdiction's rules govern, i.e., if a foreign consolidated return has been filed and accepted by the foreign jurisdiction then the group is a foreign consolidated group. The foreign jurisdiction's consolidation rules may differ from those in the U.S., which generally require that one corporation hold an 80% interest in the others (by vote or value). *See, e.g.,* I.R.C. §1504(a)(2). Regardless of jurisdiction, a principal advantage of the consolidated return is the ability to offset the earnings of one member of the group with losses incurred by another member. In addition, because affiliated group income is combined transfers of property (including cash) between members of the group can be tax exempt in the United States.
[39] There is no requirement that the group also be consolidated for U.S. tax purposes. Rather, the foreign income tax must be imposed on combined income and the members of the group must be jointly and severally liable for it. In this case the person who actually pays the foreign tax is irrelevant. *See* Treas. Reg. 1.901-2(f)(2).
[40] The local jurisdiction's treatment of expenses and capital losses, property and cash transfers between group members can result in taxable income that differs from the U.S. result. Also, the presence of a tax sharing agreement among the members of the consolidated group can affect allowed tax allocations.
[41] The U.S. assigns the 1000 of foreign tax by share of total income, i.e., 25% (or 1000 divided by 4000) to CFC2 and the remaining 75% (i.e., 3000 divided by 4000) to CFC1.
[42] Treas. Reg. 1.909-6T(b)(2).
[43] I.R.C. §909(b)(2).
[44] See Treas. Reg. 1.909-1T(a)(3). Note that this differs from the rule for consolidated filers that foreign tax is assumed paid in proportion to income. *See* Treas. Reg. 1.901-2(f)(3).
[45] *See* Treas. Reg. 1.909-6T(d)(3), (4).
[46] *See* I.R.C. §909(d)(4); Treas. Reg. 1.909-6T(d)(8)(i).
[47] Treas. Reg. 1.909-6T(d)(7), (8).
[48] On receipt of CFC2's 1000, CFC1's earnings and profits pool increases from 3000 to 4000 while its tax pool remains at 200. On distributing 1000 to USP then, the §902 tax credit equals 1000 times 200 divided by 4000, or just 50.
[49] Treas. Reg. 1.909-6T(d)(7), (8).

[50] *See Frank Lyon Co. v. United States*, 435 U.S. 561 (1978)(sham transactions are disregarded); *Greene v. United States*, 13 F.3d 577 (2d Cir. 1994)(steps will be combined, but not created, in determining appropriate tax treatment); *Gregory v. Helvering*, 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934)(transactions must have economic substance and benefit apart from mere tax reduction); *Rice's Toyota World v. Comm'r*, 752 F.2d 89 (4th Cir. 1985)(transactions must have business purpose to be given tax effect).
[51] Treas. Dept. 9577 (Feb. 14, 2012), Explanation of Provisions, §II(C)(3). *See also* Treas. Reg. 1.909-2T(b)(2)(i).
[52] *Cf.* Treas. Reg. 1.909-2T(b)(2)(vii)(example 1).
[53] *See* Treas. Reg. 301.7701-2, Treas. Reg. 301.7701-3. Note that this creates a "hybrid" structure rather than the "reverse hybrid" discussed previously.
[54] Treas. Reg. 1.909-2T(b)(2)(ii).
[55] *Ib.*
[56] Treas. Reg. 1.909-2T(b)(2)(vi).
[57] CFC3's earnings and profits are a U.S. tax aspect and so are not affected by the country X loss-sharing regime. Because CFC3 paid no country X tax, however, its final U.S. earnings and profits are the same as its earned income on the year.
[58] Treas. Reg. 1.909-2T(b)(2)(iii)(B).
[59] Treas. Reg. 1.909-2T(b)(2)(i).
[60] Treas. Reg. 1.909-2T(b)(2)(iv).
[61] Treas. Reg. 1.909-2T(b)(2)(v).
[62] *Supra at* note 50.
[63] The payments do, however, reduce CFC2's earnings and profits.
[64] Treas. Reg. 1.909-2T(b)(3)(ii)(D), (ii)(C).
[65] Treas. Reg. 1.909-2T(b)(3)(i)(B), (i)(C).