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Nature Abhors a Splitter: The FTC Splitter and Indirect FTC Rules

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This report discusses the interaction of new section 909 with sections 902 and 960. It provides discrete recommendations for the coordination of these rules and responds to recent comments by policymakers suggesting that a related income first earnings and profits distribution ordering rule might not be available prospectively under section 909.

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I. Interaction of Sections 909 and 902

Congress's enactment of section 909 added a new timing limitation on a taxpayer's ability to credit foreign income taxes incurred in connection with foreign tax credit splitting events. The statute contains only guiding principles, however, and largely leaves to Treasury and the IRS the job of weaving section 909 into the existing FTC fabric, in addition to the job of identifying what constitutes a splitting event. Several of the difficult judgment calls policymakers will face arise at the seams between section 909 and sections 902 and 960. These issues are important as well as challenging, as many, if not most, splitting events will involve foreign subsidiaries of U.S. multinationals to which sections 902 and 960 apply. This report analyzes the interaction of sections 909 and 902 from a theoretical angle and provides a set of discrete recommendations that, if followed, would make section 909 more administrable and apply section 909 most consistently with its underlying policy.

A. Section 909, Generally

Section 909 is an overlay on the otherwise applicable FTC timing rules and acts as an additional sieve through which foreign income taxes must pass before becoming creditable. It operates by delaying the time at which foreign taxes incurred in a splitting event (split foreign taxes) are taken into account for FTC purposes until the payer of the foreign taxes takes into account the related income.[1] A splitting event occurs regarding foreign taxes if the related income is or will be ''taken into account'' by a person other than the payer that qualifies as a covered person, which generally includes a corporate affiliate of the payer, as viewed through a U.S.

[1]*See* section 909(a). The payer is the person treated as paying or accruing the split foreign taxes under generally applicable FTC principles. *See* reg. section 1.901-2(f).

tax lens.[2] The statute does little to clarify how to identify the related income with respect to any particular split foreign taxes, providing only:

> The term ''related income'' means, with respect to any portion of any foreign income tax, the income (or, as appropriate, earnings and profits) to which such portion of foreign income tax relates.[3]

Section 909, thus, is drafted sufficiently broadly to cover divergently structured but similarly themed transactions and arrangements.

Section 909 represents a new solution to a problem that has vexed policymakers for some time: the separation of creditable foreign taxes from the associated E&P, as viewed from a U.S. tax perspective. Section 909 does not generally police mismatches between the time when foreign taxes are taken into account and the time when the related E&P are taken into account, so long as the same person incurs the foreign taxes and recognizes the related income for U.S. tax purposes.[4] Rather, section 909 polices mismatches in the ''location'' of tax attributes, specifically a difference between the identity of the payer of the split foreign taxes and the identity of the person that recognizes the related income, the covered person.[5] Broadly speaking, only at the time the payer bears the U.S. tax detriment of the splitting event, typically by including the related income in gross income, is the payer allowed the U.S. tax benefit of the splitting event, credits for the split foreign taxes.

One could imagine several possible solutions to the identity mismatch problem. Congress could have designed section 909 to dictate which persons take into account either the split foreign taxes or related income in particular transactions.[6] The split foreign taxes could be reallocated to the persons who recognize the related income or, at least theoretically, the related income could be reallocated to the persons that pay or accrue the split foreign taxes. Instead, Congress chose to resolve the identity mismatch problem through a timing rule.[7] Section 909, therefore, respects the determination of which person pays or accrues the split foreign taxes, as made under generally applicable FTC rules.[8]

B. Sections 902 and 960, Generally

Section 902 expands the universe of foreign taxes that are creditable by domestic corporations (and occasionally U.S. citizens or residents[9]) to include foreign taxes paid or accrued by foreign subsidiaries and also provides timing rules for taking foreign taxes into account. It is these timing rules with which section 909 must be reconciled and on which

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[2] *See* section 909(d)(1). A covered person includes:
- an entity in which the payer holds, directly or indirectly, at least 10 percent of the ownership interest, determined by voting power or value;
- any person that owns, directly or indirectly, at least 10 percent of the ownership interest, determined by voting power or value, in the payer;
- any person that is related to the payer under the rules of section 267(b) or section 707(b); and
- any other person specified in guidance.

See section 909(d)(4).

[3] Section 909(d)(3). Developing rules for identifying the related income for particular split foreign taxes likely will be challenging, as differences between foreign tax law and U.S. tax law can cause the foreign tax base (*i.e.*, the income on which foreign taxes are imposed, as viewed under foreign tax law) to not have an obvious U.S. tax analog. The difficulties that can be caused by differences between foreign tax law and U.S. tax law also are confronted in allocating foreign taxes to separate categories of income under reg. section 1.904-6 for FTC limitation ''basketing'' purposes. *See generally* reg. section 1.904-6(a)(1)(iv). For a thorough discussion of ''timing differences'' and ''base differences'' caused by differences in U.S. tax law and foreign tax law as they relate to reg. section 1.904-6, see Benjamin J. Cohen and Jay Geiger, ''Timing and Base Differences Under Section 904(d),'' 56 *Tax Law.* 3 (Fall 2002).

[4] The Joint Committee on Taxation's technical explanation of section 909 clarifies that section 909 was not intended to apply to pure timing differences. *See* JCT, ''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 Representatives on August 10, 2010,'' JCX-46-10, at 5, *2010-17846*, *2010 TNT 154-16* (JCT technical explanation) (stating: ''It is not intended that differences in the timing of when income is taken into account for U.S. and foreign tax purposes (for example, as a result of differences in the U.S. and foreign tax accounting rules) should create a foreign tax credit splitting event in cases in which the same person pays the foreign tax and takes into account the related income, but in different taxable periods'').

[5] For a discussion of the policy behind section 909 and the problems it addresses, see Rebecca Rosenberg, ''New Foreign Tax Credit Anti-Splitting Rule,'' *Tax Notes*, Nov. 8, 2010, p. 701, *Doc 2010-21599*, or *2010 TNT 217-9*.

[6] This is the approach that policymakers took in proposed regulations (the technical taxpayer regulations) that if finalized, would apply to some transactions and structures that now fall within the intended scope of section 909. *See* prop. reg. section 1.901-2(f). The technical taxpayer regulations generally would allocate foreign taxes incurred in some circumstances among persons according to their share of the foreign tax base. The potential interaction between section 909 and the technical taxpayer regulations raises a number of interesting and challenging problems. *See* Rosenberg, *supra* note 5; New York State Bar Association Tax Section, ''Report on Issues under Section 909'' (NYSBA report), at 24-25, *Doc 2010-24059*, *2010 TNT 216-25*.

[7] As an alternative to the approach adopted in section 909, Congress could have accelerated the inclusion of the related income in gross income of the payer.

[8] Reg. section 1.901-2(f)(1) provides that the person ''on whom foreign law imposes legal liability for'' the foreign taxes is treated as having paid or accrued the foreign taxes for FTC purposes. There has been considerable controversy over the meaning of this provision. *See* NYSBA report, *supra* note 6, at 5-7.

[9] *See* section 962(a).

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this report focuses. Section 902 creates rough parity, from an FTC perspective, for domestic corporations that conduct business operations abroad through foreign branches and those that do so through foreign corporate subsidiaries. A domestic corporation that satisfies ownership requirements with respect to a foreign subsidiary (such a domestic corporation is hereinafter referred to as a section 902 shareholder and such a foreign subsidiary is hereinafter referred to as a section 902 corporation) is deemed to have paid foreign taxes actually paid by the section 902 corporation on receiving a distribution of E&P from the section 902 corporation.[10] The amount of foreign taxes deemed paid by the section 902 shareholder is calculated based on a pooling mechanism that effectively averages the section 902 corporation's foreign tax rate across multiple years.

Under the pooling mechanism, a section 902 corporation aggregates its undistributed E&P and the foreign income taxes it pays or accrues for its post-1986 tax years in cumulative pools (an E&P pool and a foreign tax pool, respectively).[11] On a distribution of E&P by a section 902 corporation to a section 902 shareholder, the section 902 shareholder is deemed to have paid foreign taxes in an amount that bears the same ratio to the balance of the section 902 corporation's foreign tax pool as the amount of E&P distributed bears to the balance of the section 902 corporation's E&P pool.[12] The section 902 corporation reduces its E&P pool by the amount of the distributed E&P and reduces its foreign tax pool by the amount of deemed paid foreign taxes carried up by the distribution.

Similarly, a distribution of E&P by a lower-tier section 902 corporation to a higher-tier section 902 corporation in the same chain of ownership carries up deemed paid foreign taxes to the higher-tier section 902 corporation, such that the higher-tier section 902 corporation adjusts its E&P pool and foreign tax pool accordingly.[13] The foreign taxes, then, are deemed paid by the section 902 shareholder at the time the foreign taxes ultimately are carried up by distributions of E&P through the chain of section 902 corporations.

Section 960 extends the application of section 902 to constructive distributions of E&P by section 902 corporations deemed made in connection with subpart F inclusions.[14] Under the subpart F rules, subject to some exceptions, if a controlled foreign corporation earns certain types of passive or mobile income or makes certain investments, U.S. shareholders with respect to the CFC are taxed currently in the United States on their shares of the subpart F income as if the CFC had distributed a commensurate amount of E&P as dividends to the U.S. shareholders.[15] Section 960(a) routes these constructive distributions of E&P through section 902, so that they are treated as actual distributions of E&P for FTC purposes.[16] Because section 960 incorporates section 902 by cross-reference, any discussion of the policies and mechanics behind section 902 also is relevant to section 960.

C. Applications

Section 909 must be reconciled with the section 902 rules in two contexts:

- splitting events in which the payer is a section 902 shareholder (section 901 splitting event),[17] and the related income is taken into account by a section 902 corporation (that is, the covered person is a section 902 corporation); and
- splitting events in which the payer is a section 902 corporation, and the related income is taken into account by any covered person (section 902 splitting event).

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[10] A section 902 corporation includes a first-tier foreign corporation in which a section 902 shareholder directly owns stock representing at least 10 percent of the voting power. *See* section 902(a). A section 902 corporation also includes a lower-tier foreign corporation if:

- a section 902 shareholder owns stock representing at least 10 percent of the voting power in a first-tier foreign corporation; and
- the section 902 shareholder indirectly owns stock of the lower-tier foreign corporation representing at least 5 percent of the voting power of the lower-tier foreign corporation through a chain of foreign corporations that includes the first-tier foreign corporation connected with stock ownership representing at least 10 percent of the voting power at each tier in the chain of ownership.

See section 902(b). A section 902 corporation, however, does not include a foreign corporation below the sixth tier. *See id.* Also, a foreign corporation below the third tier can qualify as a section 902 corporation only if it qualifies as a CFC within the meaning of section 957 and the section 902 shareholder is a ''United States shareholder'' within the meaning of section 951(b) regarding the foreign corporation. *Id.*

[11] *See* section 902(c).

[12] *See* section 902(a).

[13] *See generally* section 902(b).

[14] *See* section 960(a)(1).

[15] *See* section 951(a)(1)(A) and (B).

[16] Subject to the exception provided in section 960(c), a deemed distribution of E&P under subpart F is treated as made directly by the CFC to the U.S. shareholder, so that the E&P and foreign taxes carried up by the deemed distribution ''hopscotch'' over any intermediate section 902 corporations. *See* section 960(a). *Cf.* section 960(c) (denying hopscotch treatment for deemed distributions resulting from a CFC's investment in U.S. property under section 956 if the U.S. property is acquired on or after January 1, 2011).

[17] Such a splitting event is referred to as a section 901 splitting event because the split foreign taxes would be creditable by the payer directly under section 901(a) but for the application of section 909 and any other limitations under the FTC rules.

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For section 901 splitting events, the payer is sometimes referred to as the "payer section 902 shareholder," and for section 902 splitting events, the payer is sometimes referred to as the "payer section 902 corporation." Straightforward examples can be used to illustrate these types of splitting events.

Example 1: Section 901 Splitting Event. Assume a domestic corporation, USP, wholly owns a foreign entity, FS, which is classified as a foreign corporation for U.S. tax purposes but is treated as fiscally transparent for Country X tax purposes (that is, a "reverse hybrid" entity). During Year 1, FS earns $100 of pretax income from its Country X operations, on which Country X imposes $50 of income taxes. Assume that USP is treated as paying or accruing the $50 of Country X taxes under generally applicable FTC principles because it alone is legally liable to pay the taxes under Country X tax law. Assuming that this structure qualifies as a splitting event, USP's $50 of foreign taxes constitutes split foreign taxes, and the $100 of E&P recognized by FS constitutes the related income.

Example 2: Section 902 Splitting Event. Assume the same facts as in Example 1, except that USP owns the stock of FS indirectly through a wholly owned foreign holding company, FH, which is classified as a foreign corporation for U.S. tax purposes. In Year 1, FS earns $100 of pretax income in Country X but FH, instead of USP, is treated as paying or accruing the $50 Country X tax under generally applicable FTC principles. Again assuming that the structure qualifies as a splitting event, FH's $50 of foreign taxes constitutes split foreign taxes, and FS's $100 of E&P constitutes the related income.

The relevant difference between Example 1 and Example 2 is that in Example 1, USP, a section 902 shareholder, was the payer and FS, a section 902 corporation, was the covered person, whereas in Example 2, both FH, the payer, and FS, the covered person, were section 902 corporations. Before the enactment of section 909, a section 902 splitting event could be used to "supercharge" the payer's foreign tax pool, such that distributions of E&P by the payer would carry up a relatively high amount of foreign taxes.

Section 909 contains little guidance on how it should be coordinated with section 902. It provides only that in a section 902 splitting event, the split foreign taxes are not taken into account "for purposes of section 902 or 960" or "for purposes of determining earnings and profits under section 964(a)," until the related income is taken into account by either:

- the payer section 902 corporation; or
- a section 902 shareholder with respect to such payer section 902 corporation.[18]

The statute, however, grants Treasury and the IRS general authority to issue guidance carrying out the purposes of the provision,[19] providing policymakers significant discretion to develop optimal coordination rules.

D. Coordination Issues and Recommendation

Since section 909 was enacted, commentators have taken first cracks at providing recommendations on some issues, and policymakers have issued guidance covering limited circumstances. On November 8, 2010, the New York State Bar Association (NYSBA) Tax Section issued a well-reasoned report addressing issues under section 909 and providing recommendations, which were not limited to the interaction of sections 909 and 902.[20] The NYSBA report included several recommendations and discussions pertinent to the issues addressed in this report.

On December 6, 2010, Treasury and the IRS issued Notice 2010-92,[21] providing guidance on the treatment of section 902 splitting events occurring in tax years beginning on or before December 31, 2010. Although section 909's general effective date is January 1, 2011, it effectively applies retroactively to some foreign taxes incurred in section 902 splitting events.[22] Notice 2010-92 addressed a broad range of issues and provided affirmative rules coordinating sections 909 and 902 for the splitting events falling within its limited scope, namely section 902 splitting events occurring in tax years beginning on or before December 31, 2010.[23] This report describes the approaches discussed in the NYSBA report and adopted in Notice 2010-92 and uses them to frame the alternative options policymakers have in developing prospective coordination rules.

This report focuses on three fundamental and intertwined "tracking" and "timing" issues. The first tracking issue is whether related income

[18]*See* section 909(b). *See also* JCT technical explanation, *supra* note 4, at 5-6.

[19]*See* section 909(e).

[20]*See* NYSBA report, *supra* note 6, at 12-13.

[21]2010-52 IRB 916, *Doc 2010-25933*, *2010 TNT 234-10*.

[22]*See* P.L. 111-226, section 211(c). It applies to some split foreign taxes deemed paid by a section 902 shareholder on or after January 1, 2011, as a result of receiving a distribution of earnings from a section 902 corporation, even if the split foreign taxes were incurred by the section 902 corporation in a section 902 splitting event occurring in a tax year beginning on or before December 31, 2010. Notice 2010-92 generally limits the retroactivity of section 909 to foreign taxes paid or accrued by section 902 corporations in tax years beginning on or after January 1, 1997. *See* Notice 2010-92, *supra* note 21, at 918.

[23]*See* Notice 2010-92, *supra* note 21, at 916-917.

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should be funneled through the generally applicable section 902 rules. Specifically, should related income earned by a section 902 corporation be included in its E&P pool, so that distributions by the section 902 corporation of the related income carry up foreign taxes from its foreign tax pool in addition to releasing suspended split foreign taxes? Alternatively, should related income be maintained in a segregated account separate from the section 902 corporation's E&P pool? This issue can be relevant to both section 901 splitting events and section 902 splitting events.

The second tracking issue, which is related to the first issue but is relevant only to section 902 splitting events, is whether split foreign taxes should be included in the payer's foreign tax pool and carried up by distributions of E&P not attributable to related income, even though the split foreign taxes cannot be used until the related income is taken into account. Further, by whom and in what manner should split foreign taxes be taken into account when they are released as a result of the related income being taken into account by a section 902 shareholder of the payer section 902 corporation, rather than the payer itself (an up-the-chain inclusion)?[24]

The timing issue, which is relevant to both section 901 and 902 splitting events, is how to determine whether, and to what extent, a distribution of E&P by a covered person (or any other corporation) carries up related income. The E&P distribution ordering rule chosen will affect the duration of the period during which the split foreign taxes remain suspended (that is, the time during which the splitting event remains "open").

This report argues that the following rules best implement the policies underlying sections 909 and 902:

- *Treatment of Related Income Under Section 902.* Related income would not be included in the E&P pool of any section 902 corporation, including the covered person, until it is taken into account by the payer. Rather, it would be maintained in a separate account. A distribution of related income would not carry up foreign taxes out of the distributing section 902 corporation's foreign tax pool. This approach is hereinafter referred to as a segregated E&P approach because it would require separate treatment of related income and other E&P earned by a section 902 corporation. In a section 901 splitting event, when the payer takes related income into account, it would be treated as paying or accruing a proportionate amount of the split foreign taxes.
- *Treatment of Split Foreign Taxes Incurred in Section 902 Splitting Events Under Section 902.* In a section 902 splitting event, split foreign taxes would not be included in the payer's (or any other section 902 corporation's) foreign tax pool during the period they remain suspended under section 909 and thus, would not be carried up by distributions of E&P not attributable to related income. They would be maintained in a separate account of the payer section 902 corporation until they are released. This approach is hereinafter referred to as a segregated foreign tax approach. If the related income is taken into account by the payer section 902 corporation itself, (i) the payer's E&P pool would be increased by an amount equal to the amount of related income taken into account, less a proportionate amount of split foreign taxes that are released, and (ii) its foreign tax pool would be increased by an amount equal to the amount of the released split foreign taxes. If the related income is taken into account by a section 902 shareholder regarding the payer in an up-the-chain inclusion, rather than the payer section 902 corporation itself, (i) the same adjustments would be made to the payer's E&P pool and foreign tax pool as if the payer actually had taken the related income into account, and (ii) exclusively for purposes of determining the amount of foreign taxes deemed paid by the section 902 shareholder, the payer would be treated as distributing an amount of E&P equal to the amount of the related income taken into account by the section 902 shareholder. The deemed distribution could be treated as made either directly from the payer to the section 902 shareholder or if there is one or more intermediate section 902 corporations between the payer and the section 902 shareholder, the deemed distribution could be treated as traveling through the chain of intermediate section 902 corporations. The deemed distributions of E&P would be taken into account only for purposes of deeming the section 902 shareholder to have paid or accrued foreign taxes under section 902 and would not cause the

[24]*See* section 902(b)(2). An up-the-chain inclusion could occur, for example, if:

- a splitting event involves section 902 corporations in different chains of ownership and the covered person distributes the related income up a chain that does not include the payer; or
- the covered person earns subpart F income, which could result in the covered person being deemed to distribute related income directly to the section 902 shareholder, hopscotching over the payer.

See NYSBA report, *supra* note 6, at 21. *See also* section 960(a)(1). *Cf.* section 960(c).

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distributees (including the section 902 shareholder) to include a dividend in gross income.

- *E&P Distribution Ordering Rule.* In determining whether a distribution of E&P is attributable to related income taken into account by the distributing section 902 corporation or other corporation, the distribution is attributed first to related income taken into account by the corporation and attributed to other E&P only once the related income is exhausted (the related-income, first-out (RIFO) method).

Although these rules appear to reach the most theoretically pure result, other factors must be considered. In particular, these rules would involve ''trumping'' the application of section 902's rules in some circumstances. One needs to consider whether section 909(e)'s general grant of authority permits policymakers to mandate that section 909 override section 902. For these reasons, this report does not necessarily recommend that policymakers offer these rules as the *exclusive* means of coordinating sections 909 and 902. Rather, the only recommendation this report offers is that policymakers provide taxpayers the opportunity to apply these coordination rules collectively as an alternative to any other approaches that are allowed for splitting events occurring in tax years beginning on or after January 1, 2011 (that is, splitting events not covered by Notice 2010-92). Permitting taxpayers to apply these rules would significantly reduce the administrative burden created by section 909.

II. Treatment of Related Income

A. NYSBA Report

Neither the statute nor the Joint Committee on Taxation's technical explanation of the statute (the JCT technical explanation) addresses whether a distribution by a section 902 corporation of E&P attributable to related income should carry up deemed paid foreign taxes other than the split foreign taxes under the generally applicable section 902 rules, and the NYSBA report did not provide an explicit recommendation on this issue.[25] Nonetheless, the NYSBA report assumed in its discussion of potential E&P distribution ordering rules that a distribution of E&P attributable to related income would *not* carry up foreign taxes other than the split foreign taxes.[26] Thus, the NYSBA report assumed that a segregated E&P approach would apply.

The example that the NYSBA report used to illustrate the different potential E&P distribution ordering methods made this assumption clear:

> *Example 7*: Assume that U.S. corporation P owns all the stock of foreign entity FS, which is treated as a foreign corporation for U.S. and Country X tax purposes and a pass-through for Country Y tax purposes. Assume further that in Year 1 FS has 100 in pre-tax Country X E&P on which it pays 50 in Country X tax and 100 in pre-tax Country Y E&P on which P pays 20 in Country Y tax. FS has no earnings in Year 2. FS pays a dividend of 120 to P at the beginning of Year 2, leaving 30 of unremitted E&P.
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> * * *
>
> [Under a RIFO E&P distribution ordering rule], the dividend paid by FS to P would be treated as coming first out of the 100 in Country Y ''related income,'' entitling P to claim the full credit for its Country Y taxes. The remaining 20 would be treated as paid out of FS's Country X E&P and would carry with it a Section 902 credit of 20. [Note 67. *Only distributions out of the ''other'' E&P would carry with them credits for the covered person's own foreign taxes.*] [If the dividend were treated as attributable to related income and other E&P on a proportional basis], the dividend would be treated as paid proportionately out of FS's Country X E&P of 50 (which reflects a reduction for the FS-level Country X tax) and its Country Y E&P of 100. Since only 80 of the dividend (*i.e.*, 80% of FS's Country Y E&P) would be paid out of Country Y E&P, P would be entitled to a credit of 16 of its taxes paid to Country Y (*i.e.*, 80% of FS's Country Y foreign taxes); P would be treated as receiving a dividend of 40 (80 after the Section 78 grossup) out of FS's Country X E&P with a Section 902 credit of 40.[27] [Emphasis added.]

In illustrating each of the potential E&P distribution ordering rules, the NYSBA report assumed that distributions of E&P by FS would carry up foreign taxes under section 902(a) only to the extent that the E&P was not attributable to related income. Under the RIFO method discussed first, the 20 of distributed E&P not attributable to related income carried

[25]Most of the examples used in Part II of this report involve section 901 splitting events for purposes of simplicity. The issue of how to treat E&P attributable to related income in the section 902 splitting event context cannot be comprehensively addressed without also considering how to treat the split foreign taxes, which is discussed in Part III. The conclusions reached in Part II apply to both section 901 splitting events and section 902 splitting events, however.

[26]*See* NYSBA report, *supra* note 6, at 22.

[27]*Id.* (text of footnote included in brackets).

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up 20 of foreign taxes.[28] Alternatively, under the proportional E&P distribution ordering rule discussed second (hereinafter, a pro rata method), the 40 of distributed E&P not attributable to related income carried up 40 of foreign taxes. For each given E&P distribution ordering rule, the distribution of E&P attributable to related income did not carry up foreign taxes out of FS's foreign tax pool.

B. Notice 2010-92

Notice 2010-92 does not alter the operation of section 902 for distributions of E&P attributable to related income. Notice 2010-92, therefore, funnels such E&P through the generally applicable section 902 framework (this approach is hereinafter referred to as an integrated E&P approach). Under an integrated E&P approach, a distribution by a covered person or other section 902 corporation of E&P, regardless of whether the E&P is attributable to related income, carries up an amount of foreign taxes out of its foreign tax pool determined under the generally applicable section 902(a) fraction.[29]

Example 3: Comparison of Segregated E&P Approach and Integrated E&P Approach. Assume the same facts as in Example 1, that USP, a domestic corporation, owns FS, a foreign reverse hybrid entity, and there is a splitting event in Year 1 in which USP incurs $50 of split foreign taxes and FS earns the $100 of related income. Further, assume that as of the beginning of Year 1, the balance of FS's E&P pool is $900, and the balance of its foreign tax pool is $300.[30] Thus, at the end of Year 1, USP has $50 of split foreign taxes, and FS has $100 of pretax related income, $900 of other after-tax E&P, and $300 of foreign taxes from other transactions. If a segregated E&P approach applies, FS would not include the $100 of related income in its E&P pool, and a distribution of related income to USP would not carry up foreign taxes from FS's foreign tax pool. It would only release a proportional amount of USP's suspended split foreign taxes.

In comparison, under an integrated E&P approach, FS would include the $100 of related income in its E&P pool, so that at the end of Year 1 the balance of FS's E&P pool would be $1,000. A distribution of related income to USP would both release a proportional amount of USP's suspended split foreign taxes *and* carry foreign taxes out of FS's foreign tax pool under section 902(a).

C. Segregated E&P Approach Recommendation

A segregated E&P approach better implements the "matching" policy behind section 909 than an integrated E&P approach.[31] The matching policy is based on the premise that for transactions classified as splitting events, the split foreign taxes are factually linked to E&P (the related income) recognized by another person (the covered person). This factual link is that the related income represents the closest analog, as viewed through a U.S. tax lens, to the foreign tax base on which the split foreign taxes were imposed.[32] Section 909 trumps the generally applicable FTC timing rules, deferring the accounting for the split foreign taxes when necessary to match the timing of the payer's (or, in an up-the-chain inclusion, a section 902 shareholder's) inclusion of the related income for U.S. tax purposes.[33]

From a theoretical and practical perspective, related income should *not* affect the timing of foreign taxes *other than* the split foreign taxes (that is, the matching should be exclusive). The related income generally will not be factually linked to any of the foreign taxes in the covered person's foreign tax

[28]The 20 of E&P not attributable to related income is calculated by subtracting the amount of E&P attributable to related income (100) from the total amount of the dividend (120). The 20 of foreign taxes is calculated by multiplying the balance of FS's foreign tax pool (50) by a fraction, the numerator of which is the amount of the dividend (20), and the denominator of which is the balance of FS's E&P pool (50).

[29]*See* Notice 2010-92, *supra* note 21, at 921.

[30]The balance of FS's foreign tax pool could be positive despite FS being fiscally transparent for Country X income tax purposes. For example, FS could have received distributions from a lower-tier section 902 corporation that carried up foreign taxes, FS could have had operations outside of Country X on which it was subject to foreign income tax, or FS could have succeeded to another foreign corporation's foreign taxes in a transaction described in section 381.

[31]For a discussion of the matching policy behind section 909 and the technical taxpayer regulations, see Rosenberg, *supra* note 5.

[32]Notice 2010-92's rules for identifying related income that relates to split foreign taxes are consistent with viewing the related income as the U.S. tax analog of the foreign tax base on which the split foreign taxes were imposed. *See, e.g.*, Notice 2010-92, *supra* note 21, at 919 (identifying related income that relates to reverse hybrid structure splitting events as "the [E&P] (computed for U.S. federal income tax purposes) of the reverse hybrid *attributable to the activities of the reverse hybrid that gave rise to income included in the foreign tax base* with respect to which the pre-2011 split taxes were paid or accrued" (emphasis added)).

[33]Section 909, thus, is comparable to the "straddle" loss deferral rule of section 1092(a), which generally defers the timing of loss recognition on one position that is part of a straddle to match the timing of gain recognition on the economically offsetting positions if the loss is recognized before the gain. Section 909's matching is not a two-way street: Section 909 does not accelerate the accounting for split foreign taxes when the related income is taken into account first. In this sense, section 909 is distinguishable from the "hedging transaction" timing rules of reg. section 1.446-4, which seek to match the timing of tax items generated by a hedging transaction to the timing of the tax items generated by the hedged item, regardless of whether those tax items would, except for the application of reg. section 1.446-4, be taken into account before or after the tax items generated by the hedged item.

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pool. A corollary of the related income representing the closest U.S. tax analog to the foreign tax base on which the split foreign taxes were imposed is that, in the vast majority of situations, the related income should not be the U.S. tax analog to the foreign tax base for any other foreign taxes. In most circumstances, the related income will be subject to only one foreign jurisdiction's income tax as it is earned and the foreign country will impose only a single income tax on the payer regarding the related income.[34] The idea of exclusive matching can be illustrated by applying Notice 2010-92's preliminary guidance as to the definition of related income in the context of quintessential splitting events.

Example 4: Reverse Hybrid Splitting Event. Assume the same facts as in Example 1. If rules for identifying related income similar to those in Notice 2010-92 apply, FS's $100 of Country X income would constitute the related income because it is the E&P attributable to the activities of FS that gave rise to the Country X income tax base on which the $50 of split foreign taxes were imposed.[35] The related income should not represent the foreign tax base for any other foreign taxes, as one would expect that no foreign income taxes other than the split foreign taxes would be imposed on FS's Country X business operations.

Example 5: Foreign Consolidated Group Splitting Event. Assume a domestic corporation, USP, wholly owns a Country X entity, FS1, which is classified as a foreign corporation for U.S. tax purposes and is fiscally regarded for Country X tax purposes. FS1 wholly owns FS2, another Country X entity, which is classified as a foreign corporation for U.S. tax purposes and is fiscally regarded for Country X tax purposes. Further assume that FS1 and FS2 file as a consolidated group for Country X tax purposes. During Year 1, FS1 did not earn any income for Country X tax purposes, and FS2 earned $100 of income for Country X tax purposes as a result of its Country X business activities. Country X imposed income taxes of $50 on the combined Country X income of FS1 and FS2. Assume for the sake of illustration that FS1, alone, was treated as the payer regarding the $50 of Country X income taxes. Assuming that the arrangement constitutes a splitting event, if rules for identifying related income similar to those in Notice 2010-92 apply, FS2's $100 of Country X income would constitute the related income because it is the E&P attributable to the activities of FS2 that gave rise to the Country X income tax base on which the $50 of split foreign taxes was imposed.[36] Again, one would expect that no other foreign income taxes would be imposed on such related income.

Example 6: Hybrid Instrument Splitting Event.[37] Assume a domestic corporation, USP, wholly owns a Country X entity, FS1, which is classified as a foreign corporation for U.S. tax purposes and is fiscally regarded for Country X tax purposes. FS1 wholly owns FS2, another Country X entity, which is classified as a foreign corporation for U.S. tax purposes and is fiscally regarded for Country X tax purposes. In Year 1, FS2 earns $100 of income from its Country X business operations. Also in Year 1, FS2 issues a financial instrument to FS1. The instrument is treated as equity for U.S. tax purposes and debt for Country X tax purposes (that is, the instrument is a "hybrid instrument"). FS2 accrues but does not currently pay $100 of deductible interest expense for Country X tax purposes, reducing its Country X tax liability to $0, and FS1 accrues $100 of interest income for Country X tax purposes such that it incurs $50 of Country X income taxes. For U.S. tax purposes, however, FS2 is treated as having $100 of E&P because U.S. tax law disregards the accrued "interest" (U.S. tax law would treat the actual payments as dividends when paid). Assuming that the arrangement constitutes a splitting event with FS1 as the payer of $50 of split foreign taxes, if rules for identifying related income similar to those in Notice 2010-92 were to apply, $100 of FS2's E&P would constitute the related income because that is the amount of deductible interest expense FS2 accrued.[38] The related income is identified based on the amount by which the covered person's foreign tax base is reduced by the splitting event. A consequence of identifying the related income by reference to a *reduction* in FS2's

[34]The exclusive relationship between split foreign taxes and related income could break down in fringe situations, such as where differences in foreign countries' income tax laws cause one item of economic income to form the tax base with respect to multiple impositions of income tax. These situations would appear to be the exception to the rule.

[35]*See* Notice 2010-92, *supra* note 21, at 919.

[36]*See id.* (identifying as a "pre-2011 splitter arrangement" a foreign consolidated group for which "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"; identifying the related income as the E&P, computed for U.S. tax purposes, "of such other member attributable to the activities of that other member that gave rise to income included in the foreign tax base with respect to which the pre-2011 split taxes were paid or accrued").

[37]This example is based on the example of a potential splitting event provided in the JCT technical explanation, *supra* note 4, at 6.

[38]*See* Notice 2010-92, *supra* note 21, at 919-920 (identifying as the related income in "U.S. Equity HI" splitting events "an amount equal to the amounts that are deductible by the issuer for foreign tax purposes, determined without regard to the actual amount of the issuer's earnings and profits").

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Country X foreign tax base is that one would, once again, expect that no other foreign income taxes would be imposed on the related income.[39]

A segregated E&P approach is more consistent with exclusive matching of split foreign taxes and related income in the section 902 context than an integrated E&P approach. A segregated E&P approach excludes related income from a section 902 corporation's E&P pool until it is taken into account by the payer, so that distributions of related income do not trigger the creditability of foreign taxes other than the split foreign taxes. This, in effect, treats a section 902 corporation's E&P pool, in the aggregate, as the U.S. tax analog to the foreign tax base on which the foreign taxes in its foreign tax pool were imposed, which is consistent with the concept of pooling. An integrated E&P approach, in contrast, blends the related income into a section 902 corporation's E&P pool, causing the related income to affect the timing of creditability of the foreign taxes in the section 902 corporation's foreign tax pool *as well as* the split foreign taxes.

An integrated E&P approach has two distortive effects that violate exclusive matching and that give rise to opposing but not necessarily exactly offsetting section 902 consequences. First, an integrated E&P approach dilutes the section 902 corporation's E&P pool by increasing its absolute balance (that is, increasing the denominator of the section 902(a) fraction). This reduces the amount of foreign taxes carried up out of the distributing section 902 corporation's foreign tax pool by any particular distribution of E&P not attributable to related income. Second, it increases the absolute amount of E&P deemed distributed out of the section 902 corporation's E&P pool by the amount of the distribution treated as coming out of related income (that is, increasing the numerator of the section 902(a) fraction). This causes a distribution of related income to yield two FTC benefits:

- the release of suspended split foreign taxes under the operation of section 909; and
- the carrying up of foreign taxes other than the split foreign taxes under the operation of section 902.

The distortive effects of an integrated E&P approach can be shown by comparing:

- the FTC position the payer would be in had it entered into a transaction that is economically equivalent to the "closed" portion of a splitting event in the same year in which the portion of the splitting event is deemed closed for section 909 purposes (the base case); and
- the payer's FTC position under section 909 as the splitting event is closed if an integrated E&P approach is applied.

The base case, thus, represents a hypothetical transaction undertaken by the payer in which the related income and split foreign taxes are not separated and the timing of which matches the timing of when the splitting event is deemed closed under section 909. It involves direct, actual matching at the level of the payer of:

- foreign taxes in an amount equal to the amount of the released split foreign taxes; and
- E&P in an amount equal to the amount of related income taken into account by the payer.[40]

For these purposes, a taxpayer's FTC position is measured by the effective foreign tax rate of the E&P it takes into account.[41] One would expect that if section 909 were working properly, it would place the payer in the same FTC position as it would be in under the base case because, then, the payer would be indifferent for FTC purposes to structuring a particular transaction as a splitting event in the first place.[42] The concept of the base case can be illustrated with the following example.

Example 7: Illustration of Base Case With Respect to Partially Closed Splitting Event. Assume the same facts as in Example 3. That is, USP, a domestic corporation, wholly owns FS1, a reverse

[39]This analysis would not be affected, for example, by the imposition of Country X withholding taxes on the accrued but unpaid interest on the hybrid instrument. Presumably, the withholding taxes would not constitute split foreign taxes, as the related income, as viewed for U.S. tax purposes, would be the dividends earned with respect to the hybrid instrument and would be taken into account by FS1, the payer of the withholding taxes, under generally applicable FTC principles at the time they actually are paid. The accrual of the foreign withholding taxes before the time the payments actually are made reflects a pure timing difference to which section 909 should not apply.

[40]The base case does not involve actual matching at the level of the covered person because section 909 respects the payer as the person that properly pays or accrues the split foreign taxes as determined under general FTC principles.

[41]This can be determined by dividing (1) the foreign taxes taken into account, under either section 909 or section 902, by (2) the sum of the E&P taken into account and the foreign taxes described in (1). This analysis simplifies the discussion by disregarding any section 904(d) basketing differences between the E&P attributable to the related income and the other E&P.

[42]Although the payer could manage the rate at which the splitting event is closed to the extent it controls the timing of distributions of E&P made by the covered person, this should not be considered abusive, provided that a splitting event has economic substance and does not otherwise violate FTC antiabuse principles. Presumably, the payer simply could enter into a series of transactions over time in which the foreign taxes and related income are not separated. Alternatively, the payer could have a newly formed foreign subsidiary enter into the transactions and control the timing of distributions from the foreign subsidiary.

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hybrid entity. As of the beginning of Year 2, USP has accrued $50 of suspended split foreign taxes, and FS has recognized the $100 of related income. Excluding the E&P attributable to related income, the balance of FS's E&P pool is $900, and the balance of its foreign tax pool is $300. Assume that in Year 2, FS distributes $200 of E&P to USP, and neither USP nor FS earns any additional income or incurs any additional foreign taxes. If one assumes that a pro rata E&P distribution ordering rule applies, regardless of whether an integrated or segregated E&P approach applies, 10 percent, or $20, of FS's Year 2 distribution would be attributable to related income, and 90 percent, or $180, of the distribution would be attributable to E&P other than related income.

In the economically equivalent base case, the splitting event would not have occurred in Year 1, so that USP would not have accrued the $50 of split foreign taxes in Year 1, and FS would not have incurred the $100 of related income in Year 1. In Year 2:

- FS would have distributed $180 of E&P (the portion of the base case that is economically equivalent to the distribution of E&P not attributable to related income); and
- USP would have earned $20 of Country X income and incurred $10 of Country X income taxes (the portion that is economically equivalent to the closed portion of the splitting event and in which there is actual matching).

In the base case, just as under section 909, in Year 2 USP would take into account $20 of related income and $180 of E&P not attributable to related income which is distributed by FS.

If, alternatively, one assumes that an RIFO E&P distribution ordering rule applies, $100 of FS's Year 2 distribution would be attributable to related income and the remaining $100 would be attributable to other E&P. In the economically equivalent base case:

- the splitting event would not have occurred in Year 1;
- FS would have distributed $100 of E&P in Year 2 (the portion that is economically equivalent to the distribution of E&P not attributable to related income); and
- USP would have earned $100 of Country X income and incurred $50 of Country X income taxes in Year 2 (the portion that is economically equivalent to the splitting event, which is fully closed in Year 2 under the RIFO method).

For any given E&P distribution ordering rule applied, a segregated E&P approach puts the payer in the same position as its position under the economically equivalent base case. In contrast, an integrated E&P approach achieves this parity only if a pro rata distribution ordering rule applies. Whether the two distortive effects of an integrated E&P approach, which have opposing effects, provide a net benefit or detriment in any particular case depends on the E&P distribution ordering rule adopted. This can be illustrated most clearly through an example.

Example 8: Comparison of Segregated E&P Approach, Integrated E&P Approach, and Base Case. Assume the same facts as in Example 7, except that FS distributes $200 of E&P to USP in each of years 2 through 6. Further assume that neither USP nor FS earns any additional income or pays or accrues any additional foreign taxes in years 2 through 6. Thus, at the end of Year 6, FS will have distributed all of its E&P attributable to the related income ($100) and all of its other E&P ($900), regardless of the E&P distribution ordering rule adopted.

Tables 1, 2, and 3 show USP's FTC position in years 2 through 6, disregarding any limitations on creditability other than section 909 for purposes of simplicity. Table 1 shows USP's FTC positions under a segregated E&P approach, Table 2 shows USP's FTC positions under an integrated E&P approach, and Table 3 shows USP's FTC positions under the economically equivalent base case. For each approach, the results under three potential E&P distribution ordering rules are shown:

- a RIFO method;
- a pro rata method; and
- a related-income, last-out (RILO) method, under which a distribution of E&P is deemed to come, first, out of E&P that is not attributable to related income and, only once such E&P is exhausted, out of E&P attributable to related income.

The "section 901 FTCs" represent the amount of split foreign taxes released by FS's distribution of E&P to USP (those foreign taxes are creditable by USP directly under section 901), and the "section 902 FTCs" represent the amount of foreign taxes carried up by the distribution and deemed paid by USP under section 902.

For any given distribution ordering rule adopted, USP's FTC position under a segregated E&P approach, as shown in Table 1, is identical to its FTC position in the economically equivalent base case in which there is actual matching, as shown in Table 3. In comparison, there is parity between USP's FTC position under an integrated E&P approach, as shown in Table 2, and its position in the economically equivalent base case only if a pro rata method applies. If a RIFO method applies, the integrated E&P approach places USP in a better FTC position until the end of Year 6, at which time all of FS's E&P has been distributed. Conversely, if a RILO method

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Table 1. USP's FTC Position Under Segregated E&P Approach

		RIFO	Pro Rata	RILO
Year 2 Distribution	Section 901 FTCs	$50[a]	$10[b]	$0[c]
	Section 902 FTCs	$33.33	$60	$66.66
Year 3 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$66.66	$60	$66.66
Year 4 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$66.66	$60	$66.66
Year 5 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$66.66	$60	$66.66
Year 6 Distribution	Section 901 FTCs	$0	$10	$50
	Section 902 FTCs	$66.66	$60	$33.33

[a]Under a RIFO E&P distribution ordering rule, the first $100 of FS's Year 2 E&P distribution of $200 is deemed attributable to related income. Thus, all $50 of the split foreign taxes are released in Year 2.
[b]Under a pro rata E&P distribution ordering rule, $20 of each of FS's $200 E&P distributions in years 2 through 6 is deemed attributable to related income. Thus, each distribution releases a proportional amount of the split foreign taxes ($10).
[c]Under a RILO E&P distribution ordering rule, all of the split foreign taxes are released in year 6, at the time FS's distributes its last $100 of E&P, which is deemed attributable to related income.

applies, the integrated E&P approach leaves USP in a worse FTC position until all of FS's E&P are distributed.

Although the integrated E&P approach yields the same result as a segregated E&P approach and the base case if a pro rata E&P distribution ordering rule applies, this does not necessarily support the conclusion that a pro rata method is optimal. Rather, as discussed in Part IV of this report, the E&P distribution ordering rule largely represents an arbitrary judgment as to how quickly a splitting event should be deemed closed. The reason that a pro rata method yields parity between an integrated E&P approach and a segregated approach is that the two distortive effects of the integrated E&P approach perfectly offset each other regarding each distribution. Under a pro rata method, the dilution of FS's E&P pool (the increase in the balance of FS's E&P pool, the denominator of the section 902(a) fraction) is proportionate to the ''extra'' section 902 benefit provided on the distribution of the related income (the increase in the amount of E&P deemed distributed out of FS's E&P pool, which is the numerator of the section 902(a) fraction). A RIFO method, in comparison, front-loads the beneficial distortion by assigning it to the first E&P distributed, whereas a RILO method backloads the beneficial distortion by assigning it to the last E&P distributed.[43]

Table 2. USP's FTC Position Under Integrated E&P Approach

		RIFO	Pro Rata	RILO
Year 2 Distribution	Section 901 FTCs	$50	$10	$0
	Section 902 FTCs	$60	$60	$60
Year 3 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$60	$60	$60
Year 4 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$60	$60	$60
Year 5 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$60	$60	$60
Year 6 Distribution	Section 901 FTCs	$0	$10	$50
	Section 902 FTCs	$60	$60	$60

III. Section 902 Splitting Events

A. Section 909(b)(2) and (c)(2)

Neither section 909 nor the JCT technical explanation prescribes how split foreign taxes incurred in a section 902 splitting event are to be taken into account under section 902. Section 909(b)(2) provides that in the case of a section 902 FTC splitting event, the split foreign taxes ''shall not be taken into account — (1) for purposes of section 902 or 960, or (2) for purposes of determining earnings and profits under section 964(a)'' before the year in which the section 902 corporation or a section 902 shareholder takes the related income into account.[44] Further, section 909(c)(2) provides:

> In the case of any foreign income tax not taken into account by reason of [section 909(b)], except as otherwise provided by the Secretary, such tax shall be so taken into account in the

[43]Regardless of the E&P distribution ordering rule applied, the dilutive distortion of an integrated E&P approach (the increase in the balance of the distributing section 902 corporation's E&P pool) is spread proportionately over all of the distributions made by the section 902 corporation.

[44]Section 902(b).

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Table 3. USP's FTC Position in Base Case

		RIFO	Pro Rata	RILO
Year 2 Distribution	Section 901 FTCs	$50	$10	$0
	Section 902 FTCs	$33.33	$60	$66.66
Year 3 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$66.66	$60	$66.66
Year 4 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$66.66	$60	$66.66
Year 5 Distribution	Section 901 FTCs	$0	$10	$0
	Section 902 FTCs	$66.66	$60	$66.66
Year 6 Distribution	Section 901 FTCs	$0	$10	$50
	Section 902 FTCs	$66.66	$60	$33.33

> taxable year referred to in such subsection . . . as a foreign income tax paid or accrued in such taxable year.[45]

Except to the extent guidance provides otherwise, then, the default treatment appears to be that when related income is taken into account, the payer section 902 corporation is treated as paying or accruing the split foreign taxes and should adjust its E&P pool and foreign tax pool accordingly (that is, the payer's E&P pool is increased by the amount of the related income taken into account less the released split foreign taxes, and its foreign tax pool is increased by the amount of the released split foreign taxes). The released split foreign taxes then can be carried up to section 902 shareholders by future distributions of E&P by the payer. Nonetheless, section 909(c)(2) and (e) appear to grant policymakers authority to override this default treatment when appropriate.

B. NYSBA Report

The NYSBA report did not explicitly discuss the issue of whether suspended split foreign taxes should be included in the payer's foreign tax pool before the time they are released. The NYSBA report did, however, note that special rules could be appropriate for split foreign taxes incurred in section 902 splitting events if the related income is taken into account in an up-the-chain inclusion.[46] The NYSBA report explained that an impediment to taking into account the released split foreign taxes by means of future distributions of E&P by the payer section 902 corporation could warrant special treatment:

> Section 909(b)(2) . . . provides that where a U.S. shareholder of a Section 902 corporation that paid or accrued foreign taxes in a Splitting Event takes into account the covered person's relevant E&P, the foreign tax is taken into account. The statutory language suggests that this results in the foreign tax being taken into account in the E&P and foreign tax pools of the Section 902 corporation that paid the tax, following which the normal rules of Section 902 would apply to determine when the credit can be claimed. However, in cases where the covered person's E&P bypasses the Section 902 corporation that paid the foreign tax [an up-the-chain inclusion] (*e.g.*, because the two entities are not in the same chain of ownership or the covered person makes a Section 956 investment), there may be undue impediments to ever being able to claim the foreign tax credit, especially if the Section 902 corporation no longer has any E&P at the time the related income is taken into account.[47]

Although the NYSBA report's discussion of up-the-chain inclusions appeared limited to situations in which there was some impediment to the section 902 shareholder taking the split foreign taxes into account, it recommended that guidance provide that if a section 902 shareholder takes into account the related income in an up-the-chain inclusion,

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[45]Section 902(c)(2).

[46]*See* NYSBA report, *supra* note 6, at 21.

[47]*Id.* The NYSBA report provided an example illustrating such a circumstance:

> *Example 6*: U.S. corporation P owns all the stock of foreign corporation CFC1, which in turn has a wholly-owned foreign subsidiary CFC2, which is a reverse hybrid treated as a corporation for U.S. tax purposes and a pass-through for foreign tax purposes. In Year 1, CFC2 has 100 in E&P on which CFC1 pays 30 in foreign taxes. CFC1 also has its own operations which generate 50 in E&P, which it distributes on a current basis to P. In Year 2, CFC2 makes a loan of 100 to P, which P includes in income under Section 956; CFC1 has no other E&P.
>
> The tax paid in Year 1 by CFC1 on CFC2's income is subject to Section 909 and thus cannot be claimed as a credit by P in Year 1. CFC1 is entitled to take the tax into account in Year 2 when the related income is taken into account by P as a result of CFC2's Section 956 investment. However, since CFC1 itself does not include the related income in its E&P and has no other E&P remaining, it is unclear how P can be in a position to claim the indirect credit, even though there is nothing in the policy of Section 909 that requires further deferral of the credit. It therefore may be appropriate to provide that the U.S. taxpayer can take the foreign tax into account when it recognizes the related income.

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''the foreign tax credit [for the split foreign taxes] may be claimed by the U.S. taxpayer at the time it takes into account the related income.''[48]

The NYSBA report suggested alternative approaches under which the section 902 shareholder could take split foreign taxes into account in an up-the-chain inclusion.[49] Under the first approach mentioned, the section 902 shareholder would take the released split foreign taxes into account directly at the time it took the related income into account. The section 902 corporation would reduce its E&P pool by the amount of the released split foreign taxes (but the split foreign taxes would not be included in its foreign tax pool because they already would have been taken into account by the section 902 shareholder at the top of the chain).[50] Under the second approach mentioned, the related income would be, first, deemed distributed by the covered person to the payer section 902 foreign corporation and, subsequently, deemed distributed by the payer section 902 foreign corporation to the section 902 shareholder.[51] These approaches can be illustrated with an example.

Example 9: Up-the-Chain Inclusion. Assume a domestic corporation, USP, wholly owns the stock of two brother-sister foreign corporations, FS1 and FS2. FS1 owns all of the class A stock of another foreign corporation, FS3, and FS2 owns all of the class B stock of FS3. Assume that in Year 1, FS2 and FS3 are involved in a section 902 splitting event (it does not matter what type of splitting event for these purposes), such that FS2 pays or accrues $50 of split foreign taxes, and FS3 earns the $100 of related income. Further assume that in Year 2, FS3 distributes the full $100 of related income to FS1 (that is, a non-pro-rata distribution regarding the class A stock[52]), and FS1 immediately thereafter distributes the E&P to USP. Finally, assume that there exists a sufficient impediment to FS2 distributing E&P to USP that the NYSBA report would conclude that special treatment is warranted.

Under the first approach mentioned in the NYSBA report:

- USP would be deemed to have paid the $50 of split foreign taxes in Year 2;
- FS2 would reduce its E&P pool by $50; and
- FS2 would not include the related income in its E&P pool or the split foreign taxes in its foreign tax pool.

Under the second approach noted in the NYSBA report:

- FS3 would be treated as distributing the E&P attributable to the related income to FS2 in Year 2; and
- FS2, in turn, would be treated as distributing such E&P to USP in Year 2.

Presumably, FS3's deemed distribution of E&P attributable to the related income to FS2 would not carry with it foreign taxes under section 902, as the NYSBA report assumed that a segregated E&P approach would apply.

C. Notice 2010-92

Under Notice 2010-92, split foreign taxes incurred in a section 902 FTC splitting event are included in the payer's foreign tax pool, so that a distribution of E&P by the payer is treated as carrying up split foreign taxes and other foreign taxes in its foreign tax pool on a proportional basis (hereinafter, an integrated foreign tax approach).[53] Split foreign taxes carried up by a distribution of E&P to a higher-tier section 902 corporation continue to be treated as split foreign taxes and are included in the higher-tier section 902 corporation's foreign tax pool.[54] The higher-tier section 902 corporation steps into the shoes of the distributing section 902 corporation and becomes the ''new'' payer regarding the split foreign taxes for section 909 purposes.[55] Notice 2010-92 provides that as related income is taken into account by the payer section 902 corporation or a section 902 shareholder thereof, a ratable portion of the associated split foreign taxes is released.[56]

Notice 2010-92's integrated foreign tax approach is consistent with its integrated E&P approach: Both related income and split foreign taxes are subject to section 902's general accounting rules. These approaches create a coherent, practical, and administrable system. Related income is included in the covered person's E&P pool, and a distribution of that E&P carries up foreign taxes out of the covered person's foreign tax pool. Split foreign taxes are included in the payer's foreign tax pool, and any distribution of E&P out of the payer's E&P pool carries up a proportional amount of the split foreign taxes. Notice 2010-92, however, does not provide special rules for how to take into account split

[48]*Id.* at 12.
[49]*Id.* at 22, n.66.
[50]*Id.*
[51]*Id.*
[52]A non-pro-rata distribution of the related income is used in this example for purposes of simplicity. If FS3 made a pro rata distribution of related income to FS1 and FS2, so that FS1 and FS2 each took into account $50 of related income, and FS1 and FS2 distributed the related income to USP, the $50 of related income distributed through FS1 would be taken into account in an up-the-chain inclusion, and the same issues would be raised.

[53]*See* Notice 2010-92, *supra* note 21, at 921.
[54]*Id.*
[55]*Id.*
[56]*Id.*

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foreign taxes released as a result of an up-the-chain inclusion. If the related income makes its way to a section 902 shareholder before the payer takes the related income into account, the split foreign taxes cease to constitute split foreign taxes,[57] but appear to remain at the level of the payer and become creditable only at the time they are carried up to the section 902 shareholder under the normal rules of section 902.

Example 10: Application of Integrated Foreign Tax Approach to Up-the-Chain Inclusion. Assume the same facts as in Example 9. That is, a domestic corporation, USP, directly owns all the stock of two foreign corporations, FS1 and FS2. FS1 owns all of the class A stock of FS3, and FS2 owns all of the class B stock of FS3. In Year 1, FS2 and FS3 are involved in a section 902 splitting event, with FS2 the payer of $50 of split foreign taxes and FS3 the covered person taking into account $100 of related income. In Year 2, FS3 distributes the $100 of related income to FS1 in a non-pro-rata distribution, and FS1 immediately distributes the $100 of related income to USP. In Year 2, at the time USP takes the related income into account as a result of the distributions of the related income by FS3 and FS1, the split foreign taxes are released. The split foreign taxes remain in FS2's foreign tax pool, although they lose their status as split foreign taxes, and FS2 reduces its E&P pool by a corresponding amount. Future distributions of E&P by FS2 would carry the split foreign taxes up to USP under the generally applicable rules of section 902.

Interestingly, Notice 2010-92 appears to allow for the opposite of an up-the-chain inclusion: a circumstance in which the split foreign taxes are released at the level of the section 902 shareholder as a result of the related income being taken into account at the level of a section 902 corporation (hereinafter, a down-the-chain inclusion). This would follow from the interaction of:

- the lack of a rule causing a section 902 corporation to cease constituting the payer regarding split foreign taxes carried up to a section 902 shareholder by a distribution of E&P other than related income (that is, the lack of a rule causing the section 902 shareholder to become the payer regarding the carried-up and, presumably, still suspended split foreign taxes)[58]; and
- the rule providing that "as related income is taken into account by the payer section 902 corporation or a section 902 shareholder . . . a ratable portion of the associated pre-2011 split taxes will no longer be treated as pre-2011 split taxes."[59]

It seems that when split foreign taxes are carried up by a distribution to a section 902 shareholder, the distributing section 902 corporation remains the payer regarding the split foreign taxes, and thus, if the payer takes the related income into account, the split foreign taxes are released at the level of the section 902 shareholder.

Example 11: Application of Integrated Foreign Tax Approach to Down-the-Chain Inclusion. Assume the same facts as in Example 9, except that (1) FS2 distributes E&P to USP in Year 2, and (2) FS3 and FS1 do not distribute the related income to USP in Year 2, so that the related income remains in FS3's E&P pool. FS2's Year 2 distribution of E&P to USP would carry up all or a portion of the split foreign taxes to USP. The split foreign taxes would remain suspended at the level of USP until the corresponding related income is taken into account. If FS3 were to distribute the related income to FS2, the payer section 902 corporation, a down-the-chain inclusion would result and USP would take into account the split foreign taxes.

If this reading leads to an unintended result, policymakers should clarify the proper treatment.

D. Segregated Foreign Tax Approach

As was the case regarding related income, the exclusive matching principle underlying section 909 supports exempting split foreign taxes incurred in section 902 splitting events from the generally applicable timing rules of section 902. An integrated foreign tax approach is inconsistent with the exclusive matching principle to the extent that split foreign taxes are carried up by distributions of E&P before the time the payer takes into account the related income because it entangles the accounting for the split foreign taxes with the timing of inclusion of E&P other than the related income, specifically the E&P in the payer's E&P pool. This breach of exclusive matching follows the split foreign taxes as they are carried up a chain of section 902 corporations. At each section 902 corporation in the chain, the accounting for the split foreign taxes becomes intertwined with the accounting for the E&P in its E&P pool, regardless of whether that E&P includes the related income.

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[57] *Id.*

[58] In comparison, if suspended split foreign taxes are carried up to a higher-tier section 902 corporation, the higher-tier section 902 corporation becomes the payer regarding the split foreign taxes. *See id.* This rule applies only to a "shareholder described in section 902(b)," which includes only a higher-tier

(Footnote continued in next column.)

section 902 corporation, and not a shareholder described in section 902(a), which would include a section 902 shareholder.

[59] *Id.*

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It should be possible to devise several segregated foreign tax approaches fully consistent with the matching policy, and this report discusses only one such approach, which is based on several principles. First, before their release, suspended split foreign taxes incurred in a section 902 splitting event would be held in a suspended account by the payer and would be excluded from the foreign tax pools of all section 902 corporations, including the payer's. To the extent the related income is taken into account by the payer section 902 corporation, a proportionate amount of the split foreign taxes would be released and added to the payer's foreign tax pool. The payer also would decrease its E&P pool by the amount of the released split foreign taxes to reflect that the related income represents pretax E&P.[60]

If the related income is taken into account by a section 902 shareholder in an up-the-chain inclusion, the considerations become more complicated. Although the NYSBA report's rationale for having special rules for up-the-chain inclusions was that in some circumstances, the section 902 shareholder might be unable to take the split foreign taxes into account through future distributions of E&P by the payer,[61] special up-the-chain inclusion rules are needed for more fundamental reasons. They are needed to create parity between a taxpayer's FTC position under section 909 and the economically equivalent base case, thus limiting section 909's deferral effect to that which is necessary to achieve matching, and to create parity between section 901 and 902 splitting events.[62]

It seems unassailably good policy to limit section 909's deferral effect to that which is necessary to achieve matching. Section 909 should be viewed as a curative, rather than a punitive, rule. It was drafted sufficiently broadly to cover varied transactions and structures, including both highly structured transactions intended to reduce a taxpayer's U.S. tax liability and arrangements that arise naturally from differences in U.S. and foreign tax law. Indeed, splitting events in many cases will result from deliberate choices made by U.S. policymakers, such as the promulgation of the check-the-box entity classification regulations.[63] Section 909 does not require a tax avoidance motive, and there is no legislative history suggesting that section 909 was intended to punish taxpayers. Thus, section 909 should not operate to defer the creditability of split foreign taxes more than is necessary.

In the case of an up-the-chain inclusion, merely adjusting the E&P pool and foreign tax pool of the payer section 902 corporation to account for the released split foreign taxes does not return the relevant section 902 shareholder to the economically equivalent base case. The section 902 shareholder *actually* includes the related income in gross income for U.S. tax purposes. Failing to provide the section 902 shareholder the benefit of deemed paid foreign taxes with respect to this income inclusion would cause section 909 to defer the creditability of split foreign taxes beyond the time necessary to achieve matching and punish the section 902 shareholder. Further, because this possibility of extra deferral would exist only in the section 902 splitting event context, it would create disparity between economically equivalent section 901 splitting events and section 902 splitting events, running afoul of the general policy behind section 902 of creating FTC parity for U.S. multinationals that conduct operations abroad through branches and those that do so through foreign subsidiaries.

Example 12: Base Case With Respect to Up-the-Chain Inclusion. Assume the same facts as Example 9. Assuming that a segregated E&P approach and segregated foreign tax approach apply, if special rules are not adopted for up-the-chain inclusions, USP's FTC position under section 909 would be worse than it would be under the economically equivalent base case. USP would take into account the $100 of related income in Year 2, but it could take into account the split foreign taxes only as FS2 makes future distributions. In the economically equivalent base case:

- FS2 and FS3 would not have been involved in the splitting event in Year 1;
- in Year 2, FS2 would undertake a transaction involving actual matching in which it took into account $100 of E&P and incurred $50 of foreign taxes (the actual matching of the split foreign taxes and related income at the level of the payer according to the timing provided in section 909); and
- in Year 2, FS2 would distribute $100 of E&P to USP (the portion of the base case equivalent to USP's inclusion of the related income in gross income). USP would include the dividend in its gross income and would be deemed to have paid foreign taxes under section 902.

[60]A segregated foreign tax approach would eliminate the possibility of a down-the-chain inclusion because the split foreign taxes would remain suspended at the level of the payer section 902 corporation until they are released.

[61]*See* NYSBA report, *supra* note 6, at 21-22.

[62]Special up-the-chain inclusion rules would, in no event, "accelerate" accounting for split foreign taxes. Absent section 909, split foreign taxes would be taken into account at the time they are paid or accrued.

[63]*See* reg. sections 301.7701-1 through -3.

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Section 909, therefore, would defer the time USP could take the split foreign taxes into account beyond that which is necessary to achieve matching.[64]

The economically equivalent base case could be reached through several steps, which are similar to the steps outlined in the second approach mentioned in the NYSBA report. First, exclusively for purposes of deeming the section 902 shareholder to have paid or accrued foreign taxes, the payer section 902 corporation would be treated as if it had taken the related income into account directly. Accordingly, the payer would:

- increase its E&P pool by the amount of the related income;
- increase its foreign tax pool by the amount of the released split foreign taxes; and
- decrease its E&P pool by the amount of the released split foreign taxes, again to reflect that the related income represents pretax E&P.

Second, again exclusively for purposes of deeming the section 902 shareholder to have paid or accrued foreign taxes, the payer would be treated as distributing an amount of E&P equal to the amount of the related income taken into account to the relevant section 902 shareholder. This deemed distribution could be treated as hopscotching over any intermediate section 902 corporations or could be treated as distributed successively through any section 902 corporations in the same chain of ownership.[65] Any deemed distribution or deemed successive distributions would carry up foreign taxes under the general rules of section 902.[66]

The section 902 shareholder would not include the deemed dividend in income, however, as doing so would double count the related income. Similarly, if the distribution were deemed to travel through a chain of section 902 corporations, they would not be treated as receiving dividends for other tax purposes (for example, for subpart F purposes) because they would not have *actually* received income.[67] The intermediate section 902 corporations would increase and decrease the balance of their E&P pools by exactly offsetting amounts to reflect the distribution deemed received and the distribution deemed paid, so that there would be no net change. The balances of the intermediate section 902 corporation's foreign tax pools would change, however, as a result of the release of the split foreign taxes and the carrying up of deemed paid foreign taxes to the section 902 shareholder.

Example 13: Application of Segregated Foreign Tax Approach to Up-the-Chain Inclusion. Assume the same facts as in Example 9. Further assume that at the beginning of Year 1, the balance of FS2's E&P pool is $900, and the balance of its foreign tax pool is $300, and that FS1, FS2, and FS3 earn no additional income and incur no additional foreign taxes. In Year 2, at the time USP takes into account the related income as a result of the actual successive distributions of the related income by FS3 and FS1, FS2 would be treated as if it earned the related income and the split foreign taxes would be released.[68] FS2 would increase its E&P pool by $50 (equal to the $100 of related income, less the $50 of split foreign taxes) and increase its foreign tax pool by $50, so that the balance of its E&P pool would be $950 and the balance of its foreign tax pool would

[64]Another consequence of failing to provide special rules for up-the-chain inclusions would be to create disparity between economically equivalent "releasing" transactions. For example, assume the same facts as Example 9, except that FS3 distributes the related income to FS2 (rather than FS1), the payer, and then FS2 distributes the related income to USP. The split foreign taxes are released upon FS3's distribution to FS2, and FS2's distribution to USP carries up foreign taxes under the ordinary operation of section 902(a). USP is in an economically equivalent position compared with the up-the-chain inclusion in Example 9 because in both instances, it has included $100 of related income in gross income. Thus, one would expect that if section 909 were working properly, the FTC consequences of these economically equivalent releasing events would be the same.

[65]Conventions would be needed to determine the path the related income would be deemed to take to reach the section 902 shareholder when more than one route is available through intermediate section 902 corporations and when the related income actually is taken into account by a domestic affiliate of a section 902 shareholder of the payer. Notice 2010-92 provides that a section 902 shareholder is considered to have taken related income into account if one or more members of an affiliated group of corporations, as defined in section 1504, that files a consolidated U.S. federal income tax return that includes the section 902 shareholder takes the related income into account. *See id.*

[66]In the case of an up-the-chain inclusion, it would be an inappropriate shortcut to deem the section 902 shareholder on taking the related income into account to have paid the split foreign taxes. Section 909 respects the determination of the payer of the split foreign taxes under general FTC principles, and in a section 902 splitting event, the person treated as paying or accruing the split foreign taxes is the section 902 corporation. Thus, the ultimate accounting for the split foreign taxes should be determined after they are released by applying the pooling mechanism of section 902.

[67]It would be necessary to consider how the section 904(d) basketing rules would apply to the deemed distributions. One approach would be to treat the payer section 902 corporation as earning the related income for basketing purposes as well, and to basket the section 902 shareholder's income inclusion as if it actually received the deemed distributions.

[68]Under the segregated E&P approach, discussed in Part II of this report, the distributions by FS1 and FS3 of the related income would not carry up foreign taxes out of FS1's or FS3's foreign tax pool.

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be $350. FS2 then would be treated as if it made a distribution of $100 out of its E&P pool to USP, which would carry up $36.84 of foreign taxes.[69] USP also would take into account a section 78 gross-up of $36.84. FS2 would reduce its E&P pool by $100 to $850 and would reduce its foreign tax pool by $36.84 to $313.16.

If, instead, USP owned FS2 indirectly through a foreign holding corporation, FH, FS2 could be deemed to distribute the $100 of E&P to USP, exclusively for purposes of deeming USP to have paid foreign taxes, either indirectly through FH or directly under a hopscotch approach. Under the former approach, the amount of foreign taxes ultimately carried up to USP would be determined by applying section 902, first, to FS's distribution to FH and, second, to FH's subsequent distribution to USP. One potential approach would be to apply a deemed hopscotch analysis if the related income would have created a hopscotch inclusion if it actually were earned by FS3, and to apply a deemed successive distribution analysis otherwise. Regardless of whether a hopscotch or successive distribution analysis were applied, the amount of foreign taxes deemed paid by USP would not necessarily equal the amount of released split foreign taxes.

IV. E&P Distribution Ordering Rule

An E&P distribution ordering rule will prove an important cog in the mechanics of section 909 because for most splitting events involving corporations, the split foreign taxes and related income will be reunited through distributions of E&P. Nonetheless, neither section 909 nor the JCT technical explanation addresses how to identify when, and to what extent, a distribution of E&P by a covered person or other corporation to a shareholder is treated as attributable to related income.

A. NYSBA Report

The NYSBA report identified four possible distribution ordering conventions:

- a ''related income E&P first method'' (herein called a RIFO method), which would treat actual and deemed distributions of E&P as first attributable to related income and, only once related income is exhausted, out of other earnings;
- a ''proportional method'' (herein called a pro rata method), which would treat distributions of E&P as attributable to related income and other earnings on a proportional basis;
- a ''related income E&P last method'' (herein called a RILO method), which would treat distributions of E&P as first attributable to earnings other than related income and, only once the other earnings are exhausted, as attributable to related income; and
- a ''tracing method,'' in which distributions would be attributed to related income or other earnings based on a factual relationship between the distribution and the splitting event.[70]

Although other conventions are conceivable, such as an annual layering method, the NYSBA report appears to have identified the most promising potential rules.

The NYSBA report concluded that a pro rata method was the most preferable method for general application, although it also noted comparative advantages of a RIFO method.[71] It stated:

> It can be argued that [a RIFO method] is preferable because it generally results in the income and foreign tax associated with the Splitting Event being brought together more quickly. This reduces administrative complexity for the Service and the taxpayer by reducing the delay in the U.S. taxpayer's ability to credit or deduct the foreign taxes beyond what is required by the policy of Section 909. In addition, it reduces the likelihood of encountering the issues [arising from the disaffiliation of the payer and the covered person during the period the splitting event is open]. However, we believe that [a pro rata method] is preferable, primarily because it is more consistent with the general scheme of Section 902. In addition, [a RIFO method] is potentially more

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[69]The $36.84 is calculated by multiplying the pre-distribution balance of FS2's foreign tax pool ($350) by a fraction, the numerator of which is the amount of the distribution ($100) and the denominator of which is the pre-distribution balance of FS2's E&P pool ($950).

[70]*See* NYSBA report, *supra* note 6, at 22-23.

[71]*See id.* The NYSBA report recommended against the general use of either the tracing method or a RILO method. *See id.* It concluded that the tracing method would be too difficult to administer and potentially would be subject to taxpayer manipulation, although it noted that the tracing method could be the most appropriate method for some splitting events involving hybrid instruments. *See id.* at 22. The NYSBA report explained that a RILO method would maximize the period during which the separated foreign taxes and related income would remain asunder, increasing the possibility that transactions occurring during that period would complicate the treatment under section 909. *See id.* at 22-23. The NYSBA report also noted that although a RILO method would deter taxpayers from entering into splitting events, ''such incremental disincentive — especially where the result is permanent denial of the credit — seems to be beyond what is contemplated by the statute.'' *See id.* at 23. The NYSBA report's rejection of the tracing method and RILO method as generally applicable ordering rules appears to be appropriate for the reasons the NYSBA report provided.

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> susceptible to taxpayer manipulation, although which method maximizes the foreign tax credit in a particular situation will depend on the relative rates of foreign tax on the covered person's related income and other income.[72]

Thus, the NYSBA report recommended a pro rata method over a RIFO method for two reasons:

- a pro rata method is more consistent with principles of section 902; and
- a RIFO method is more susceptible to taxpayer manipulation.

B. Notice 2010-92

Notice 2010-92 adopted a pro rata method as the default rule, so that unless a taxpayer elects otherwise, if a corporation has E&P attributable to related income as well as other E&P, actual and deemed distributions of E&P by the corporation are treated as attributable to related income and other income on a proportional basis.[73] A taxpayer, however, is permitted to elect to apply a RIFO method, but only if it does so for all its pre-2011 splitting events.[74] Shortly after the release of Notice 2010-92, however, senior policymakers indicated that the RIFO method might not be made available in prospective guidance covering future splitting events not falling within the scope of Notice 2010-92.[75]

C. RIFO Method Recommendation

Any E&P distribution ordering rule that is not based on a factual relationship between the distributed E&P and the splitting event is inherently arbitrary and if a segregated E&P approach and segregated foreign tax approach were applied, would merely reflect a determination of how quickly splitting events should be deemed closed.[76] If a segregated E&P approach and segregated foreign tax approach apply, each of a RIFO, pro rata, and RILO method implement the matching policy. This report argues that although the NYSBA report identified the most important considerations, it understated the case for a RIFO method and overstated the case for a pro rata method. Out of a RIFO, pro rata, and RILO method, a RIFO method would be optimal because it would minimize section 909's deferral effect and would minimize the administrative burden associated with section 909.

Section 909, at its core, is an exception to generally applicable FTC timing rules. Thus, while section 909 should be viewed as a solution to aberrant transactions, it is itself a timing aberration in that split foreign taxes otherwise would be taken into account at the time they are paid or accrued, regardless of when the related income is taken into account by the payer. A RIFO method achieves matching of the split foreign taxes and related income most efficiently, minimizing the duration of the period during which section 909 remains relevant to a taxpayer's FTC position. Consider a splitting event in which the covered person is not a section 902 corporation (for example, the covered person could be a foreign subsidiary below the sixth tier or below the third tier and not a CFC). Distributions of E&P other than related income by the covered person would not carry up deemed paid foreign taxes. It would seem unduly harsh to apply an E&P distribution ordering rule other than the RIFO method in that context.

In this sense, a RIFO method draws support from the E&P distribution ordering rule adopted under the "previously taxed income" (PTI) rules of section 959.[77] Section 909 is analogous to the subpart F

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[72] *Id.* The NYSBA report made a specific recommendation:

> [That] guidance provide that where a covered person has E&P from related income as well as other E&P, distributions generally are deemed to come proportionally out of E&P arising from related income and other income, although we note that there are arguments in favor of treating distributions as coming first out of related income E&P. In the case of hybrid instruments, tracing may be appropriate to determine when related income is taken into account.

Id. at 13.

[73] *See* Notice 2010-92, *supra* note 21, at 920.

[74] *See id.*

[75] *See* Lee A. Sheppard, "IRS Discusses Foreign Tax Credit Splitter Notice," *Tax Notes*, Dec. 13, 2010, p. 1166, *Doc 2010-26079* or *2010 TNT 235-1*; Kristen A. Parillo, "U.S. Officials Address FTC Splitter Notice, Sunsetting Regs," *Tax Notes*, Dec. 13, 2010, p. 1182, *Doc 2010-26227*, or *2010 TNT 237-6*.

[76] As explained in Section II of this report, however, if an integrated E&P approach is adopted, the E&P distribution ordering rule can change the taxpayer's FTC position as compared to the economically equivalent base case.

[77] Also, Congress intended that the passive foreign investment company rules adopt an approach similar to the PTI rules of section 959. Under the qualified electing fund (QEF) subregime in the PFIC rules, a U.S. person that owns stock of a QEF is taxed currently on its share of the QEF's E&P. *See* section 1293(a)(1). As under the subpart F rules, previously taxed E&P of a QEF that is distributed to a U.S. person is not taxed a second time, provided that the U.S. person can prove the distribution was paid out of previously taxed E&P. *See* section 1293(c). Congress intended that Treasury and the IRS issue regulations providing ordering rules like those found in section 959(c). S. Rep. No. 445 (1988) ("The committee anticipates that regulations will be prescribed to segregate a qualified electing fund's earnings and profits between earnings and profits that have been included currently in income and earnings and profits that have not been so included (because they are highly taxed or are effectively connected with a U.S. trade or business) and to prescribe ordering rules for characterizing distributions of those earnings. In this regard, the committee intends that the regulations follow the approach of section 959(c), relating to the ordering rules of previously taxed earnings and profits and other earnings and profits of a controlled foreign corporation,

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anti-deferral regime. Subpart F generally accelerates taxation in the U.S. if a CFC earns certain types of passive or mobile income or makes certain investments by treating the United States shareholders of the CFC as if they had received distributions of E&P from the CFC.[78] The acceleration of dividends under subpart F parallels the deferral of payment or accrual of foreign taxes under section 909. Subpart F hastens a typically detrimental tax event by deeming a distribution to have been made, whereas section 909 defers a typically beneficial tax event by suspending the payment or accrual of the split foreign taxes until related income is distributed.

Just like section 909, the subpart F rules require an E&P distribution ordering rule to unwind their tax re-characterization, and in both contexts, the E&P distribution ordering rule merely determines how quickly the re-characterization is unwound. To prevent double taxation after a subpart F inclusion, a U.S. shareholder is not taxed on the actual distribution by the CFC of the E&P that gave rise to the subpart F inclusion (PTI).[79] Section 959 provides a PTI-first-out E&P distribution ordering rule that treats distributions of E&P by a CFC first to come out of PTI and only once PTI is exhausted, out of other E&P.[80] The effect of this rule is that subpart F's accelerated inclusions are closed out as quickly as possible. The considerations applicable in the subpart F context appear to be present in the section 909 context, as well.

A RIFO method also would be the most administrable rule. A pro rata or RILO method, in comparison to a RIFO method, would not fully close any particular splitting event until all of the covered person's E&P is distributed. These methods would in many cases leave a splitting event open for as long as the covered person remains in existence, as many foreign subsidiaries do not fully repatriate their E&P until they liquidate. Forcing splitting events to have such long tails would unnecessarily burden taxpayers and the IRS. A domestic parent corporation could be required to track each splitting event that either it or one of its foreign subsidiaries enters into for an indefinite period. Each distribution of E&P then would need to be sliced into component tranches representing the portion of the distribution applicable to each such splitting event. To the extent a taxpayer had an uncertain position under section 909, it would need to report that position for tax and financial accounting purposes indefinitely. One can imagine the compliance nightmare this could become.

Although the NYSBA report noted that a RIFO method generally would be more susceptible to taxpayer manipulation than a pro rata method,[81] if a segregated E&P approach and segregated foreign tax approach apply, each of a RIFO, pro rata, and RILO method eliminates the *ex ante* incentive a taxpayer might have to structure a transaction as a splitting event. Regardless of the E&P distribution ordering rule adopted, the taxpayer cannot obtain the FTC benefit of the splitting event until it recognizes the related income. Thus, the taxpayer should be indifferent from a FTC perspective. That the payer could manage the rate at which the splitting event is closed by controlling the timing of distributions of E&P made by the covered person should not be viewed as abusive because, presumably, the taxpayer could enter into the economically equivalent base case transactions at any time or could have a newly formed foreign subsidiary enter into a transaction economically equivalent to the splitting event and control the timing of distributions from the subsidiary.

A RIFO rule would not necessarily be taxpayer favorable. If a segregated E&P approach and segregated foreign tax approach apply, the E&P distribution ordering rule that is most favorable regarding a particular splitting event depends on the respective effective foreign tax rates to which the related income and the covered person's other E&P (as reflected in its E&P pool and foreign tax pool) were subject. If the related income is subject to a higher foreign effective tax rate than the covered person's other E&P, a RIFO method would be most favorable, followed, in order, by a pro rata method and RILO method. In contrast, if the related income is subject to a lower foreign effective tax rate than the covered person's other E&P, a RILO method would be most favorable, followed, in order by a pro rata method and a RIFO method.[82]

The other advantage of a pro rata method over a RIFO method cited by the NYSBA report was that it would be consistent with the principles of section 902,[83] presumably the pooling principles. If one views section 909 as reflecting an exclusive matching principle, this argument stretches pooling beyond its

and provide that earnings and profits included currently in income be considered distributed before other earnings and profits.'').

[78]*See* section 951(a)(1)(A) and (B).

[79]*See* section 959(a).

[80]*See* section 959(c).

[81]*See* NYSBA report, *supra* note 6, at 23.

[82]It would seem reasonable to require taxpayers to use a consistent E&P distribution ordering method regarding all of its splitting events.

[83]*See* NYSBA report, *supra* note 6, at 23.

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intended purpose. Congress intended pooling to reduce timing distortions caused by the annual ''layering'' rules in place before the Tax Reform Act of 1986.[84] Pooling effectively averages the foreign taxes actually paid or accrued by a section 902 corporation that are carried up by any particular distribution of E&P by the section 902 corporation. A pro rata method would have a different effect: it would average for any particular distribution of E&P by a covered person the total of:

- the foreign taxes released under section 909, which are paid or accrued by a person *other than* the covered person; and
- the foreign taxes actually paid or accrued by the section 902 corporation carried up under the normal rules of section 902 by a distribution of E&P by a covered person.

The premise behind a segregated E&P approach and segregated foreign tax approach is that the accounting for the related income should be disassociated from the accounting for foreign taxes other than the split foreign taxes, and the accounting for split foreign taxes should be disassociated from the accounting for E&P other than the related income.

V. Conclusion

This report attempts to address concerns voiced by policymakers with a RIFO E&P distribution ordering rule. Under a segregated E&P approach and segregated foreign tax approach, no E&P distribution ordering method can be too generous, as each method merely matches the timing of the split foreign taxes with the timing of the related income, no more, no less. Only if one assumes that an integrated E&P approach and an integrated foreign tax approach apply could a particular E&P distribution ordering method appear too generous. Skewed section 909 consequences result not from the E&P distribution ordering method selected, which represents an arbitrary speed at which a splitting event is deemed closed, but rather from the distortive effects an integrated E&P approach and integrated foreign tax approach have on section 902's timing rules.

[84]*See* JCT, ''General Explanation of the Tax Reform Act of 1986'' (1987), at 869-870.

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