

## IRS to Issue Regulations Addressing Tax Splitter Transactions: Target Is EU State Aid Investigations but Restrictions to Be Broader

***Action prompted by concerns that settlements of EU State Aid tax investigations may result in inappropriate foreign tax credit splitter structures.***

On September 15, 2016, the US Internal Revenue Service (the IRS) issued Notice 2016-52 (the Notice), stating that it intends to issue regulations under Section 909<sup>1</sup> to broaden the scope of existing foreign tax credit (FTC) splitter rules. In the Notice, the IRS made clear its concern that payments of foreign taxes attributable to the recent high profile EU State Aid investigations could allow taxpayers to separate a large tax payment from the income to which it relates for FTC purposes, thus apparently violating the policy Congress set forth in enacting Section 909 as part of the Education, Jobs and Medicaid Assistance Act of 2010.

The EU State Aid investigations and decisions have resulted in considerable coverage in the business press, and prompted sharp comments on both sides of the Atlantic. EU officials have targeted the planning structures and advance pricing agreements of large multinational corporations with operations in countries such as Ireland, the Netherlands and Luxembourg. The EU has alleged that these countries and certain taxpayers entered into agreements that violated EU State Aid rules, by providing a selective advantage to the taxpayers in violation of EU competition law. The EU's overall approach, combined with the disproportionately large number of US multinationals on which the EU has focused, has prompted sharp reactions against the EU by the US Congress, Treasury Department and business community. Notice 2016-52 is the first official guidance issued by the IRS with regard to the EU State Aid issues.

As has been the case with other IRS guidance addressing high profile international tax issues (such as inversions and earnings stripping), Notice 2016-52 goes well beyond the stated target of EU State Aid tax adjustments, and can result in application of the FTC splitter rules in situations involving relatively routine foreign tax settlements for as low as US\$10 million.

### Section 909: Background

Section 909 imposes a broad matching rule to prevent the separation or "splitting" of creditable foreign income taxes from the related income. Upon specified "foreign tax credit splitting events," Section 909 bars a US taxpayer from claiming an FTC for payment or accrual of foreign taxes (split taxes) before the taxable year in which the US taxpayer takes the related income into account. Temporary and proposed regulations issued in 2012 — and adopted, with minor modifications, as final regulations in 2015 — list four categories of arrangements (each, an FTC Splitter Arrangement) that give rise to such splitting events:

- Reverse hybrid splitter arrangements, in which a payor pays or accrues foreign income taxes with respect to income of a reverse hybrid — *i.e.*, an entity that is a corporation for US federal income tax purposes but is a pass-through, or is a branch, under the law of a foreign country imposing tax on the entity's income
- Loss-sharing splitter arrangements, in which a US combined income group (as specially defined) could have used certain losses to offset its own income, but instead those losses are used to offset foreign taxable income of another US combined income group
- Hybrid instrument splitter arrangements, which generally involve certain mismatches of income and deductions with respect to instruments whose treatment as either equity or debt for US federal income tax purposes differs from the treatment under the law of the relevant foreign jurisdiction
- Partnership inter-branch splitter arrangements, in which, broadly speaking, an allocation of foreign income tax paid or accrued by a partnership with respect to a payment from one branch to another branch of the partnership is not allocated to partners in the same ratios applicable for allocating the partnership's "creditable foreign tax expenditures" to designated categories

To these categories of FTC Splitter Arrangements, the Notice adds the arrangements described below.

## **Approach Under Notice 2016-52**

The Notice targets FTCs resulting from foreign-initiated adjustments, and introduces several terms relevant to determining whether an arrangement in connection with a foreign-initiated adjustment is an FTC Splitter Arrangement.

"Covered taxes" are foreign income taxes that:

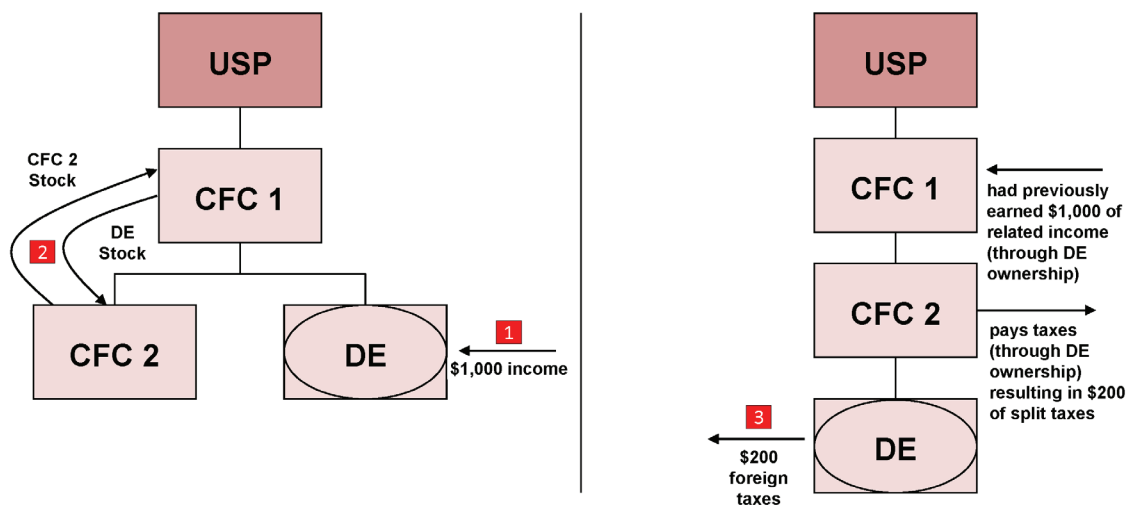
- Are generally taken into account for FTC purposes by adjusting the payor's pools of post-1986 undistributed earnings and post-1986 foreign income taxes when paid; and
- Result from a foreign tax payment (a specified foreign-initiated adjustment) with respect to one or more prior taxable years (relation-back years)

A "covered transaction" very generally is any transaction that results in covered taxes being paid by a person who did not accrue the related income in the relation-back year.

There is an exception to the term covered transaction where the relevant earnings to which the taxes relate are in fact transferred to the payor, for example in a merger or liquidation. In that case, there would have been no separation of the related income and the relevant taxes. A second exception exists if the taxpayer demonstrates by clear and convincing evidence that the transaction or series of related transactions were not structured with a principal purpose of separating covered taxes from the earnings to which the covered taxes relate.

The term "related income" generally means earnings and profits for each of the relation-back years that are attributable to all activities that gave rise to income (computed under foreign law) included in the foreign tax base that was adjusted pursuant to the specified foreign-initiated adjustment.

The following example illustrates the proposed rule in respect of covered transactions:



- 1** DE earns \$1,000 and neither accrues nor pays any foreign tax. This \$1,000 is applied to CFC 1's post-1986 pool of undistributed earnings.
- 2** In the following year, CFC 1 contributes all of its interest in DE to CFC 2 in a Section 351 transaction.
- 3** In a later year, DE pays \$200 of foreign tax to settle adjustments proposed by Country X with respect to the \$1,000 of income.

**Result Under the Notice:**

- The \$200 of taxes are "covered taxes."
- The transfer of DE interests is a "covered transaction" because it results in CFC 2 being the payor of taxes, whereas CFC 1 accrued the \$1,000 of "related income."

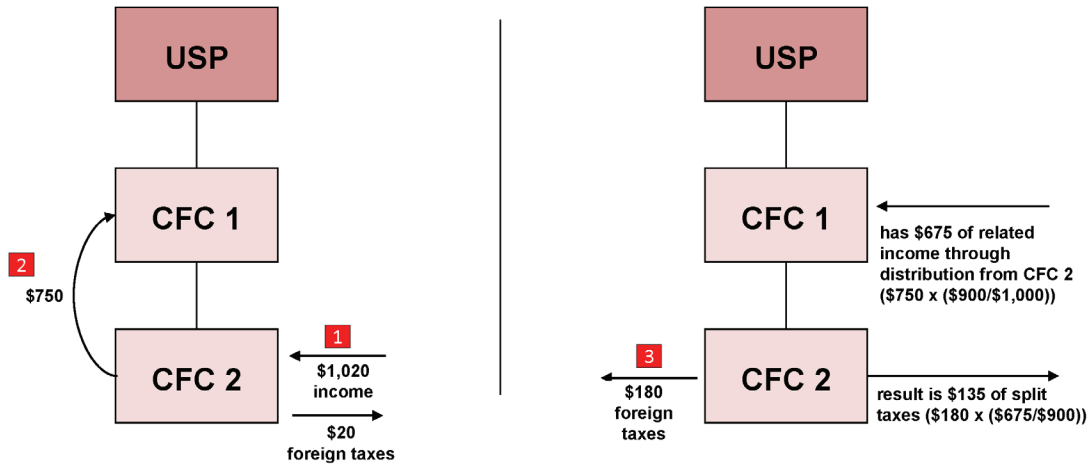
Therefore, absent an exception, CFC 2's payment of the covered taxes as a result of the covered transaction gives rise to a "splitter arrangement," and the \$200 are "split taxes" subject to Section 909.

The Notice goes on to state that taxpayers could also achieve a splitter result by using distributions to, in effect, move undistributed earnings from one subsidiary to another subsidiary before the first subsidiary makes a tax payment pursuant to a specified foreign-initiated adjustment. Accordingly, the IRS intends to issue regulations that will provide that a splitter arrangement results when a subsidiary pays covered taxes during a taxable year (the splitter year), and such subsidiary has made a "covered distribution."

A covered distribution is any distribution with respect to the first subsidiary's stock to the extent such distribution was made with a principal purpose of reducing the first subsidiary's undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes.

A distribution will be presumed to have been made with a principal purpose described immediately above if the sum of all distributions that would be covered distributions without regard to the principal purpose requirement is greater than 50% of the sum of (i) the first subsidiary's post-1986 undistributed earnings as of the beginning of the taxable year in which the covered tax is paid, and (ii) all distributions that would be covered distributions without regard to the principal purpose requirement. A taxpayer may rebut this presumption with clear and convincing evidence that the distribution was not made with a principal purpose of reducing the first subsidiary's post-1986 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes.

The following example illustrates the proposed rule in respect of covered distributions:



- 1** CFC 2 earns \$900 total in years 1-9 and neither accrues nor pays any foreign tax. In year 10, CFC 2 earns \$120 and pays \$20 of foreign tax. Accordingly, CFC has \$1,000 of post-1986 undistributed earnings at the end of year 10.
- 2** In year 11, CFC 2 distributes \$750 to CFC 1 as a dividend.
- 3** In year 12 (the splitter year), CFC 2 pays \$180 of foreign tax (the covered taxes) to settle adjustments proposed by Country X with respect to the \$900 of income earned in years 1-9.

**Result Under the Notice:**

- The \$750 distribution is presumed to be a “covered distribution,” as it is (i) made to CFC 1 in a year prior to CFC 2 having paid covered taxes, and (ii) greater than 50% of the sum of (A) CFC 2’s post-1986 undistributed earnings as of the beginning of the splitter year (\$250) and (B) such distribution (\$750).
- CFC 1 would also be treated as having \$675 of “related income” as of the beginning of the splitter year, which is the pro rata amount accorded to it under the regulations promulgated under Section 909.

Therefore, absent an exception, the \$750 distribution and subsequent payment of foreign taxes would give rise to a “splitter arrangement,” and \$135 of the \$180 foreign tax paid will be “split taxes” subject to Section 909.

The regulations described in the Notice will apply to foreign income taxes paid on or after September 15, 2016. The IRS has solicited comments on the rules described in the Notice. Such comments must be received by December 14, 2016.

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**Endnotes**

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<sup>1</sup> All references herein to "Section" are to the US Internal Revenue Code of 1986, as amended.