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# Section 909 and Loss Surrender: Temporary Regulations Strike Balance

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On February 9, 2012, the U.S. Treasury issued temporary regulations providing guidance as to the scope and application of §909 (the ''Temporary Regulations'').[1] Section 909 generally provides, in the case of a ''foreign tax credit splitting event,'' for the suspension of foreign taxes paid or accrued by a U.S. taxpayer or §902 company until the ''related income'' is taken into account by that person for U.S. income tax purposes. While the core arrangements Congress appeared to be targeting were well known, the breadth of the statutory language, coupled with statements by policymakers at Treasury and the Internal Revenue Service as to the potentially expansive scope of the statute, gave rise to considerable uncertainty. In that context, the clarity provided by the regulations is welcome. By setting forth an exclusive list of foreign tax credit splitting events, the Temporary Regulations do not leave taxpayers guessing as to whether foreign taxes have been inappropriately separated from related income. In this regard, they follow the course set by Notice 2010-92, issued on December 6, 2010 (the ''Notice'').[2]

One type of foreign tax credit splitting event identified by the Temporary Regulations is a ''loss-sharing splitter arrangement,'' which refers to the surrender of losses in certain narrow circumstances under a loss surrender or group relief system. While the Notice also identified a foreign tax credit splitting event related to loss sharing (or surrender) in certain narrow circumstances involving disregarded debt, the Temporary Regulations diverge from the Notice in their approach to loss sharing under a group relief system.

The purpose of this article is to explore the application of §909 to group relief systems. It argues that, while the application of §909 to the surrender of losses in a group relief system is not mandated by the statute and may not have been intended, the policy lines drawn by the Temporary Regulations are sensible and better fulfill the purposes of the statute than those in the Notice. It also provides technical observations and suggestions regarding the mechanical rules applicable to foreign tax credit splitting events in the group relief context.

## SUMMARY OF GROUP RELIEF SYSTEMS[3]

Under a typical group relief system, such as that of the United Kingdom, a corporation with losses is per-

[1] T.D. 9577, 77 Fed. Reg. 8127 (2/14/12).

[2] 2010-52 I.R.B. 916 (12/6/10).

[3] This summary of group relief systems is by no means exhaustive. U.S. tax practitioners and policymakers likely are most familiar with the United Kingdom's group relief system, but other countries such as Ireland and Singapore also use group relief. See, e.g., Nias, Ross, Khvat, and Morison, 989 T.M. (Bloomberg BNA Tax & Accounting), *Business Operations in the United Kingdom*,

mitted to share its losses with a profitable affiliate. The policies in favor of such loss sharing are similar to those underlying the U.S. consolidated return rules — namely, to reduce the effect that the separate existence of related companies operating in one jurisdiction has on the aggregate tax liability of the group and thereby promote tax equity without regard to whether affiliated businesses are organized in one tax person or several. The operation of a group relief system, however, differs from consolidation in important ways. Most pertinently, the U.S. consolidated return rules determine taxable income on a consolidated basis so long as the group has elected to file a consolidated return. In effect, the losses of any one affiliate are shared among the profitable affiliates on a mandatory but indeterminate basis. In contrast, under group relief, losses are shared on an elective, affiliate-by-affiliate basis.

In the United Kingdom, an affiliate with a loss for a year may make an election (limited to that year) to surrender its loss to a profitable affiliate, which may use that loss only to offset current year income. The U.K. system provides several limitations on the ability to share losses using group relief, distinguishing, for example, between trading losses and non-trading losses and in some cases between losses incurred in different lines of business.

While the decision on whether and to which affiliate to surrender a loss is elective, there may be business or local tax considerations that might cause a company to surrender to a particular affiliate rather than another. For example, depending on the management structure of the group, it might be desirable to surrender a loss to an affiliate in the same business line. Further, expectations regarding future profitability of particular affiliates, coupled with limitations on the carryover of losses, may influence the choice of affiliate to which to surrender losses to maximize the effectiveness of such surrender. Additionally, because under the U.K. system the affiliated group is determined using a 75% parent-subsidiary or brother-sister ownership threshold, it is possible to share losses with an affiliate with a minority shareholder. In such cases, the group may insist on compensation from the minority shareholder or, alternatively, may choose instead to surrender losses to a 100% affiliate, if possible.

Taxpayers with U.K. operations employ group relief first and foremost as a way of managing and minimizing U.K. taxes. Given the various restrictions on loss surrender, and the different business and tax considerations that taxpayers face in making their group relief elections, it is generally important for taxpayers to retain flexibility in determining how to share U.K. losses.

## ENACTMENT OF §909

The U.S. foreign tax credit system is designed to mitigate double taxation of the same income. Very generally, §901 provides U.S. taxpayers with a credit for foreign taxes paid on income recognized and otherwise taxable in the U.S. system, limited by the amount of the U.S. tax that would have been due on such income. When a U.S. corporate shareholder owns 10% or more of the stock of a foreign subsidiary (a ''§902 corporation'') from which it receives dividends, §902 provides the U.S. corporation with a credit for foreign taxes paid by the foreign subsidiary. In such a case, foreign taxes are taken into account in proportion to the ratio of foreign taxes to earnings and profits on a subsidiary-by-subsidiary basis.[4]

Under longstanding law, determinations related to the foreign tax paid, including the identity of the payor, are made largely with reference to foreign law, while determinations related to the income associated with the foreign taxes, including the computation of the earnings and profits of foreign subsidiaries and more generally the limitation on creditable taxes, are made with reference to U.S. law.[5] Thus, unless a foreign tax system aligns perfectly with the U.S. tax system, foreign taxes will be paid on a base that is different from the U.S. base for purposes of determining the foreign tax credit limitation, and foreign taxes may be paid by a person that is different than the person treated as earning the income from a U.S. perspective. These phenomena are ubiquitous and stem inexorably from the structure of the foreign tax credit system. However, in certain cases, it may be that taxpayers arrange their affairs in a manner intended to artificially split foreign taxes from associated income. The advent of disregarded entities under the entity classification rules has increased the opportunities for mischief in this regard.[6]

The enactment of §909 was motivated by abusive techniques designed to inappropriately split foreign

at V, B, 6; Ryan, O'Shea, and Fahy, 965 T.M. (Bloomberg BNA Tax & Accounting), *Business Operations in the Republic of Ireland*, at V, C, 14; Teoh and Seah, 983 T.M. (Bloomberg BNA Tax & Accounting), *Business Operations in Singapore*, at V, B, 3.

[4] §902; Regs. §1.902-1.

[5] *See, e.g., Abbott Laboratories Int'l Co. v. U.S.*, 160 F. Supp. 32 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959) (denying §901 foreign tax credits to U.S. parent corporation for taxes paid by foreign entities classified as corporations under U.S. tax law, without regard to local law classification of entities as pass-through entities).

[6] *See Guardian Industries Corp. v. U.S.*, 477 F.3d 1368 (Fed. Cir. 2007) (under foreign consolidated group regime, parent, a disregarded entity for U.S. purposes, had sole legal liability for the foreign tax, even though subsidiary earned the income under foreign law and for U.S. earnings and profits purposes).


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taxes from the foreign income for U.S. income tax purposes associated with the foreign income on which the taxes were imposed. Section 909 does not appear intended to alter the structure of the foreign tax credit system by addressing all cases in which the tax base on which foreign taxes are imposed under foreign law differs from that determined under U.S. principles.[7] It is noteworthy in this regard that §909 was initially proposed along with a proposal that would have required determination of the foreign tax credit under §902 on a blended or pooled basis rather than on a company-by-company basis, limiting the §902 foreign tax credit with reference to the average rate of total foreign tax actually paid by a taxpayer's foreign subsidiaries on total foreign earnings and profits (E&P) of those subsidiaries. This pooling proposal would have fundamentally altered the foreign tax credit system as applied to foreign taxes paid by subsidiaries.[8] In contrast, the House Ways and Means Committee press release accompanying the introduction of a bill including the foreign tax credit splitter provisions, observes that ''[t]axpayers have devised several techniques for splitting foreign taxes from the foreign income on which those taxes were paid.''[9] The release further states that the bill ''targets *abusive techniques* and does not affect timing differences that result from normal tax accounting differences between foreign and U.S. tax rules.''[10] Other background materials express similar sentiments.[11]

The language of §909, however, does not refer directly to any particular transaction or arrangement. Rather, it provides that ''[t]here is a foreign tax credit splitting event with respect to a foreign income tax if the related income is (or will be) taken into account under this chapter by a covered person.''[12] The term ''related income'' is defined, circularly, as ''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.''[13] A ''covered person'' is a person who is related to the payor of the foreign income tax, with a 10% vote or value test for relatedness.

Although the statute provides little guidance as to when foreign income taxes have been inappropriately separated from the income to which those taxes relate, some specific arrangements clearly were targeted by the legislation. For example, the structure at issue in *Guardian Industries* and similar structures involving reverse hybrid entities were squarely within the sights of the §909 drafters given that, from a U.S. perspective, the foreign tax liability is incurred by one person, but the income that gives rise to the tax is earned by a related person. Section 909(e) provides further clues as to the arrangements intended to be targeted, providing Treasury with regulatory authority to provide guidance for the proper application of the statute with respect to hybrid instruments. Although §909 has no formal legislative history, the Joint Committee on Taxation (JCT) published Technical Explanations of §909 — the ''May 2010 JCT Explanation'' and the ''July 2010 JCT Explanation'' — that elaborated on the reference to hybrid instruments by setting forth an example in which a hybrid instrument was used to create foreign income and tax in a company that earned no income for U.S. tax purposes.[14]

The JCT Technical Explanations raise questions about the extent to which §909 was intended to apply more broadly than *Guardian Industries*, reverse hybrid, or hybrid instrument structures. In particular, the JCT explanations raise questions about the extent to which the statute was intended to apply to loss surrender or similar regimes. The May 2010 JCT Explanation indicated that guidance was expected to address the application of §909 to ''cases involving disregarded payments or other arrangements having a similar effect.''[15] The May 2010 JCT Explanation also provided that ''[f]or purposes of determining related income,'' guidance should address ''the treatment of losses, deficits in earnings and profits, and certain timing differences between U.S. and foreign tax law.''[16] The May 2010 JCT Explanation gave no indication that losses could be considered to create a foreign tax credit splitting event. The July 2010 JCT Explanation

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[7] For a similar view, *see* West and Varma, ''The Past and Future of the Foreign Tax Credit,'' 90 *Taxes* 27, 43 (Mar. 2012) (§909 ''seems less an attempt to further better foreign tax credit 'policy' and more of an attempt to target perceived inappropriate planning opportunities to raise revenue'').

[8] *See General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (''2010 Greenbook''), at 30–31 (May 2009).

[9] *See* House Ways and Means Committee press release on ''H.R. XXX — 'Small Business Tax Relief Act of 2010' '' (7/30/10).

[10] *Id.* (emphasis added).

[11] *See, e.g.,* 2010 Greenbook, at 30 (''Current law permits *inappropriate* separation of creditable foreign taxes from the associated foreign income in certain cases such as those involving hybrid arrangements.'') (emphasis added).

[12] §909(d)(1).

[13] §909(d)(3).

[14] *Technical Explanation of the Revenue Provisions Contained in the ''American Jobs and Closing Tax Loopholes Act of 2010,'' for Consideration on the Floor of the House of Representatives*, JCX-29-10 (5/28/10) (''May 2010 JCT Explanation''), at 229; *Technical Explanation of the Revenue Provisions of H.R. 5982, the ''Small Business Tax Relief Act of 2010,''* JCX-43-10 (7/30/10) (''July 2010 JCT Explanation''), at 8.

[15] May 2010 JCT Explanation, at 229.

[16] *Id.* at 228.


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referred explicitly to "group relief" but left open the question of whether or how §909 was intended to apply to group relief. The July 2010 JCT Explanation stated, "It is anticipated that the Secretary may also provide guidance as to the proper application of the provision in cases involving disregarded payments, group relief, or other arrangements having a similar effect."[17] At the same time, the July 2010 JCT Explanation clarified that timing differences were not intended to create a foreign tax credit splitting event so long as "the same person pays the foreign tax and takes into account the related income, but in different taxable periods."[18]

Beyond the clearest cases, therefore, it is difficult to determine under the statute whether an arrangement was intended to constitute, or actually constitutes, a foreign tax credit splitting event. This is particularly true of loss surrender or group relief regimes. The reference to group relief in the July 2010 JCT Explanation admittedly is ambiguous. Given the evolution of the language from May 2010 to July 2010, it is not clear whether the JCT expressed a view that group relief was similar to a disregarded payment and an intention that subsequent guidance would treat group relief as a foreign tax credit splitting event, or instead expressed concern that it would be inappropriate to apply §909 to group relief, as in the case of timing differences. As discussed above, a group relief system permits loss sharing among related persons in ways that differ from the U.S. consolidated group system. A group relief system does not cause foreign tax to be imposed on income that was earned by a related person in the way that parallels a *Guardian Industries* or reverse hybrid structure. The statutory language alone would not appear to implicate group relief structures because in those arrangements a person pays foreign tax on income that it earned from the foreign tax perspective, and the legislative history is ambiguous as to whether Treasury should clarify the rules by explicitly excepting group relief from the application of §909 or by applying §909 to group relief where its utilization leads to inappropriate results. Ultimately, whether or not group relief was within the sights of the Congress, the broad statutory language, coupled with the reference to group relief in the July 2010 JCT Explanation, put group relief within the sights of Treasury and the IRS as the guidance process began.

## THE NOTICE

The Notice, the first piece of guidance under §909, primarily addressed taxes paid or accrued by §902 corporations in pre-2011 taxable years. Despite this transitional character, however, the Notice set parameters around the definition of a foreign tax credit splitting event that ultimately informed the route taken in the Temporary Regulations. Under the Notice, foreign tax credit splitting events were limited to four enumerated arrangements: (1) reverse hybrid structures; (2) certain foreign consolidated groups (*Guardian Industries* structures); (3) specific arrangements involving "group relief and other loss-sharing regimes"; and (4) specific hybrid instrument arrangements.

With respect to group relief, the Notice provided that a foreign tax credit splitting event occurred only when three conditions were present: (1) there is an instrument that is treated like debt for foreign tax purposes but is disregarded for U.S. tax purposes (a "disregarded debt instrument"); (2) the owner of the disregarded debt instrument pays foreign tax on the disregarded interest; and (3) the issuer's payment or accrual of the disregarded interest gives rise to a deduction for foreign tax purposes, and the issuer incurs a loss that it surrenders to a covered person. When the three conditions were met, the Notice provided that the loss surrender arrangement had the effect of separating foreign income from creditable taxes.

The arrangement targeted by the Notice is illustrated by Example 1 below. In this example, DRE1 lends funds to DRE2. Both disregarded entities are owned by CFC1, and each disregarded entity is a U.K. resident. DRE2 uses the loan proceeds to equity fund a U.K. subsidiary, CFC2. DRE2 pays interest, which generates a local country loss, and DRE1 has an offsetting amount of local country income. DRE1, DRE2, and CFC2 are entities resident in the same country, the United Kingdom, which has a group relief system. For U.S. tax purposes, CFC1 is considered to pay the tax imposed on the income of DRE1. DRE2 then surrenders its loss to CFC2, whose tax is thereby reduced. From a U.S. tax perspective, the local law loss of DRE2 does not exist; this loss is a mere interdivisional item that is offset by the corresponding disregarded income item in DRE1.

The conclusion that DRE2's loss surrender causes a foreign tax credit splitting event seems defensible. The result of the arrangement is that CFC1 is treated as incurring tax from a local law perspective without earning any income from a U.S. perspective, while CFC2 is treated as earning income from a U.S. perspective. Moreover, there is no obvious commercial or foreign tax motivation for the arrangement. The foreign taxes paid in the arrangement are the same as what would be paid absent the arrangement, and it is not clear why DRE2 could not surrender its loss to DRE1 and therefore match the local law tax base to the tax base under U.S. principles. CFC1's foreign tax is therefore properly suspended until CFC2's income

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[17] July 2010 JCT Explanation, at 8. Section 909(e) provides regulatory authority to make "appropriate exceptions" to the application of §909.

[18] *Id.* at 7.


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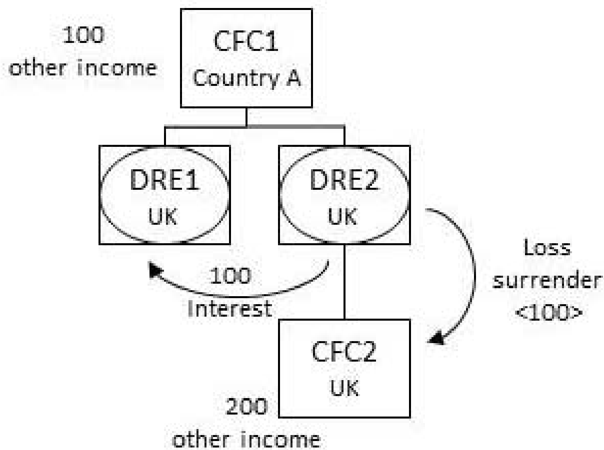
**Example 1: Same-Country Disregarded Loan**




is taken into account. It is possible that the Notice specifically targeted the use of disregarded payments in group relief to effectuate the reference in the July 2010 JCT Explanation to ‘‘cases involving disregarded payments, group relief, or other arrangements having a similar effect.’’[19]

Although it seems appropriate for the Notice to target the structure in Example 1, questions remained regarding the scope of §909 to group relief in future years. The Notice requested comments on whether ‘‘group relief structures not otherwise described in this notice’’ should be considered a foreign tax credit splitting event. In this regard, comments published in 2010 by the New York State Bar Association (NYSBA) shortly before the issuance of the Notice provide insight as to the types of group relief situations that policymakers were evaluating.[20] The 2010 NYSBA Report set out potential approaches to group relief that were more expansive than the approach provided in the Notice, including an approach that would have identified foreign tax credit splitting events by tracking the use of surrendered losses over a multi-year period.[21] More directly, the 2010 NYSBA Report stated that §909 should apply to group relief situations in which ‘‘the splitting of income and foreign tax liability occurs in a single year and it is therefore certain that the payor of the tax could have used the surrendered loss to offset foreign tax on income that the U.S. treats as the payor’s own income.’’[22] This recommendation was ultimately reflected in the Temporary Regulations.

Although the Notice may have been too narrow in some respects, the disregarded debt rule adopted in the Notice was also overbroad in other respects. For example, if in Example 1, DRE1 and DRE2 were in different countries, the taxpayer may employ disregarded debt in order to reduce foreign taxes (e.g., if DRE1 were subject to a lower tax rate than DRE2) and in fact increase residual U.S. tax. This scenario is illustrated in Example 2 below. In Example 2, it is not possible for DRE2 to surrender its loss to DRE1 or to CFC1 because they are in different countries. Therefore, the only entity to which DRE2 can surrender its loss is CFC2, a covered person. The result of the Notice seems strained when one considers that the country imposing the tax at issue, the country of DRE1, is different from the country that will tax the ‘‘related income’’ of CFC2, and indeed has no jurisdiction to tax such income. Further, the result cuts against an important policy underlying the foreign tax credit system — i.e., that foreign taxes should be minimized where possible — by leaving the taxpayer a choice between minimizing foreign tax or triggering the rules of §909.[23] Considerable uncertainty therefore remained after the issuance of the Notice.

## THE TEMPORARY REGULATIONS

Like the Notice, the Temporary Regulations identify several enumerated transactions that constitute ‘‘splitter arrangements.’’[24] These splitter arrangements are: (1) reverse hybrid splitter arrangements; (2) loss-sharing splitter arrangements; (3) hybrid instrument splitter arrangements; and (4) partnership inter-branch payment splitter arrangements.[25]

With respect to loss-sharing splitter arrangements, the Temporary Regulations depart from the Notice’s

[19] July 2010 JCT Explanation, at 8.

[20] New York State Bar Association, ‘‘Report on Issues Under Section 909’’ (11/8/10) (‘‘2010 NYSBA Report’’).

[21] *Id.*, at 28 (describing the application of §909 on a multi-year basis as ‘‘arguably appropriate’’ because it produces the same net result as a foreign tax credit splitting event, but questioning whether such an application ‘‘unduly stretches the statutory language.’’).

[22] *Id.*, at 29.

[23] It has been suggested that the failure to surrender losses to reduce foreign taxes paid could jeopardize the creditability of those taxes. *See* NYSBA, ‘‘Report on Proposed Section 901 Regulations Relating to Compulsory Payments of Foreign Taxes’’ (10/25/07), at 17–18; *cf.* TAM 200807015 (11/7/07) (indicating that failure to surrender losses to a particular affiliate under U.K. group relief regime may result in noncompulsory payment that is not eligible for foreign tax credit). Under proposed regulations issued in 2007, loss surrender within a group of foreign corporations that are 80% owned by a domestic corporation does not cause a foreign tax paid by the surrendering group member to be noncompulsory. *See* Prop. Regs. §1.901-2(e)(5)(iii).

[24] Regs. §1.909-2T(b).

[25] *Id.* The Temporary Regulations do not treat *Guardian Industries* transactions as splitter arrangements for post-2011 taxable years because, under amendments to the §901 regulations, in the case of a foreign consolidated group foreign tax must be apportioned among the group members based on each member’s portion of group income. *See* Regs. §1.901-2(f)(3).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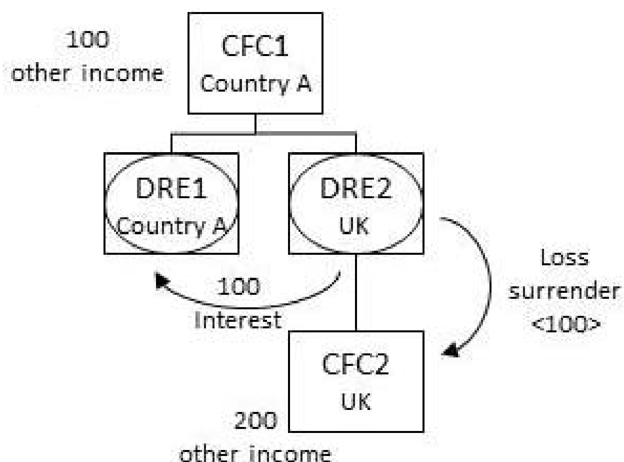
**Example 2: Two-Country Disregarded Loan**




approach to identifying foreign tax credit splitting events. Instead of limiting the application of §909 to the sharing of losses that arise from a disregarded debt instrument, the Temporary Regulations introduce the concept of a ''U.S. combined income group'' to identify loss-sharing splitter arrangements. The purpose of this concept is to treat loss-sharing arrangements as foreign tax credit splitter arrangements only when the payor of a foreign tax could have used a shared loss to offset foreign tax on income that is treated as the payor's own income under U.S. tax principles. Accordingly, under the Temporary Regulations, a loss-sharing splitter arrangement occurs ''to the extent that a shared loss of a U.S. combined income group could have been used to offset income of that group (a ''useable shared loss'') but is used instead to offset income of another U.S. combined income group.''[26]

A U.S. combined income group is an individual or corporation and all disregarded entities or partnerships whose income and deductions are combined with the income and deductions of the individual or corporation. For this purpose, a branch is treated as an entity, all members of a U.S. consolidated group are treated as a single corporation, and individuals filing a joint return are treated as a single individual.[27] If one member of the U.S. combined group has a loss that can be used to offset income of another member, the Temporary Regulations provide that the failure to share the loss within the U.S. combined income group first before it is surrendered to a related person outside the U.S. combined income group will result in a foreign tax credit splitting event.

The U.S. combined income group rule seems sensible from a policy perspective. A taxpayer that operates through disregarded entities should not be able to utilize the hybridity of those entities from a U.S. perspective to separate foreign taxes from income. A critical and appropriate limitation of the rule is that loss surrender creates an inappropriate splitting of taxes and income *only* when the taxpayer has the opportunity to surrender its loss to a part of ''itself'' but chooses instead to surrender it to another person. If there is no opportunity to surrender the loss within the U.S. combined income group, then the taxpayer may avail itself of group relief without running afoul of the Temporary Regulations or the policies underlying §909.

Applying the Temporary Regulations to Example 1 above, CFC1, DRE1, and DRE2 are members of the same U.S. combined income group. CFC2 is not a member of CFC1's U.S. combined income group because it is not a transparent entity and its items of income are not included in CFC1's income for U.S. tax purposes. DRE2 has a shared loss. (It is irrelevant that the shared loss arises from a disregarded transaction.) Furthermore, DRE2's shared loss is a useable shared loss because it could have been used to offset the income of DRE1, a member of its U.S. combined income group. Because DRE2 instead surrenders its useable shared loss outside the U.S. combined income group to CFC2, the loss sharing gives rise to a foreign tax credit splitting event.

Whereas the Notice targeted loss-sharing arrangements only when the shared loss arose from a disregarded debt instrument, the approach taken by the Temporary Regulations does not depend on the provenance of the shared loss. This result seems reasonable as well. An operating loss can just as easily cause a foreign tax credit splitting event as a loss from disregarded interest expense, in the event that the loss is shared outside of the U.S. combined income group. Perhaps because of this distinction, the Preamble to the Temporary Regulations describes the new rule as ''expand[ing] the types of loss-sharing arrangements that Notice 2010-92 treats as splitter arrangements.''[28]

In some respects, however, the approach taken by the Temporary Regulations cannot be described as an expansion of the Notice. In particular, the requirement that a shared loss be a ''useable shared loss'' in order for a foreign tax credit splitting event to exist limits the rule in cross-border disregarded debt arrangements. Applying the Temporary Regulations to Example 2 above, DRE2's loss is not a ''useable shared loss'' because it could not be used to offset the income of any member of DRE2's U.S. combined group. CFC1 and DRE1 are each located in Country A, whereas DRE2 is located in the United Kingdom, and Country A does not permit DRE2's U.K. loss to re-

[26] Regs. §1.909-2T(b)(2)(i).

[27] Regs. §1.909-2T(b)(2)(ii).

[28] 77 Fed. Reg. at 8131 (2/14/12).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duce Country A taxes. Therefore, the loss-sharing arrangement does not give rise to a foreign tax credit splitter arrangement. This result is appropriate because CFC1 is legitimately reducing its U.K. taxes.

The U.S. combined income group rule applies only to post-2011 taxable years. For 2010 and 2011, the application of §909 to group relief is limited to disregarded debt instruments as set forth in the Notice.[29] As illustrated above, there are arrangements, notably cross-border disregarded debt arrangements, that are not considered loss-sharing splitter arrangements under the Temporary Regulations even though they would be so treated under the Notice. Taxpayers with cross-border disregarded debt arrangements are subject to §909 in 2011, but not in 2012. This is not appropriate given that Treasury has made the policy decision that such arrangements should not be within the scope of §909 going forward. For such taxpayers, Treasury might consider permitting an election to apply the Temporary Regulations retroactively to 2011.[30]

One additional feature of the Temporary Regulations that was not present in the Notice is a special provision for deductible disregarded payments. According to this provision, taxes paid or accrued with respect to a disregarded payment that is deductible under foreign law are subject to §909 if the payor of the disregarded payment is subject to foreign tax on related income from a splitter arrangement.[31] This rule prevents a taxpayer that engages in a splitter arrangement from reducing the amount of split foreign income tax by making deductible payments and instead paying a withholding tax on that payment. In such a case, the withholding tax acts as a substitute for a portion of the foreign income tax that is subject to §909. Although this provision was not introduced until the Temporary Regulations, it applies retroactively to taxable years beginning on or after January 1, 2011. The retroactive application here is problematic because there was no similar provision in the Notice.[32] Perhaps of greater concern, for taxpayers with cross-border disregarded debt instruments subject to §909 under the Notice, withholding tax on deductible payments is considered a split tax under Regs. §1.909-3T(b), even though the cross-border disregarded debt itself is not considered a splitter arrangement under the Temporary Regulations. Treasury might reconsider the retroactive application of this rule. Alternatively, if, as recommended above, Treasury permits an election to apply the Temporary Regulations retroactively to 2011, taxpayers with arrangements that were foreign tax credit splitting events under the Notice but are not under the Temporary Regulations would not suffer additional insult to injury.

## APPLYING §909

The Temporary Regulations primarily address the critical threshold definition of a foreign tax credit splitting event. While the Temporary Regulations are generally helpful in setting forth clear standards for identifying when the use of group relief causes a foreign tax credit splitting event, some questions do remain. For example, the definition of a ''useable shared loss'' does not expressly limit itself to losses incurred in one taxable year that ''could have been used to offset income'' of the same U.S. combined income group in the same taxable year.[33] Government officials have stated that they did not intend to adopt a ''wait-and-see'' approach whereby a loss is considered ''useable'' if it could be carried forward in the future and used to offset future income of the same U.S. combined income group.[34] Moreover, as currently worded, the Temporary Regulations could be read to apply to a situation in which a loss could be carried back to offset prior year income of the same U.S. combined income group, which theoretically would cause a prior year's foreign taxes paid by that U.S. combined income group (which were reflected in prior year filings and may have been credited against U.S. tax in the case of an intervening dividend) to ''spring'' into §909. These results appear unintended and would be very difficult to administer, and clarification on the treatment of both carryforwards and carrybacks would be welcome.[35]

Additionally, once it is established that a transaction or arrangement constitutes a foreign tax credit splitting event, questions remain regarding how to apply §909 to foreign taxes and related income. The Temporary Regulations provide that distributions by a

[29] *See* Regs. §§1.909-5T(a)(1), -6T(b)(3).

[30] By comparison, Treasury provided taxpayers with an election to apply the allocation rules for foreign consolidated groups retroactively to taxable years beginning after Dec. 31, 2010, and thereby avoid the application of §909 to those years with respect to such groups. *See* Regs. §1.901-2(h)(4).

[31] Regs. §1.909-3T(b).

[32] There is little doubt that Treasury had the authority to provide for this result on a retroactive basis. *See* §7805(b)(2) (permitting retroactive regulations where those regulations are issued within 18 months of the enactment of the statute).

[33] Regs. §1.909-2T(b)(2)(i).

[34] *See* Sapirie, ''Officials Describe Decisions in Drafting FTC Splitter Guidance,'' 134 *Tax Notes* 1219 (3/5/12).

[35] *See* NYSBA, ''Report on Temporary and Proposed 'Splitter' Regulations and Final Technical Taxpayer Regulations'' (10/2/12) (''2012 NYSBA Report''), at 16–18 (requesting clarification on whether the definition of a ''useable shared loss'' extended to losses that could be carried back or forward, and pointing out the administrative complexity that results from applying the concept to loss carrybacks and carryforwards).


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§902 corporation are treated as made pro rata out of related income and other E&P.[36] Under this rule, split taxes may not be entirely unsuspended until the covered person has distributed all of its E&P. In contrast, the Notice had provided an election to treat distributions as made out of related income first (the so-called ''RIFO'' election). Government officials have stated that the RIFO election was intended as an accommodation to taxpayers who sought to clean up pre-2011 splitter arrangements during the transitional period following the enactment of §909.[37]

[36] *See* Regs. §1.909-3T(a).

[37] Notice 2010-92, §4.06(b)(4).

Taxpayers currently have little guidance as to the mechanics of relating income to suspended taxes, in particular where the related income for U.S. E&P purposes differs in some way from the foreign tax base. For example, the amount of related income arising from a loss-sharing splitter arrangement is defined as ''an amount of income of the individual or corporate member of the U.S. combined income group equal to the amount of income of that U.S. combined income group that is offset by the useable shared loss of another U.S. combined income group.''[38] If a U.S. combined income group benefits from a shared loss, the amount of its income that is reduced by the shared loss is considered related income. Consider, however, a case where the U.S. E&P constituting the related income is lower than the foreign tax base because of a timing difference. In a future year, the U.S. combined income group may have additional U.S. E&P to make up for this timing difference. The subsequently recognized E&P may be related income.[39]

If E&P earned in a year subsequent to the year of the split foreign tax can be related income, there is also a question as to whether losses in the subsequent year can reduce the related income. In the case of reverse hybrid splitter arrangements, the Notice and the Temporary Regulations explicitly defined related income as a floating concept that is adjusted to account for future income and losses that comprise the foreign tax base on which the split tax was imposed.[40] The Temporary Regulations do not address, however, the effect of future losses or E&P deficits on related income associated with a loss-sharing splitter event. If future losses are not permitted to reduce related income, then split taxes under §909 may be in danger of indefinite suspension. This seems like an unduly harsh result that should be remedied in future guidance.

There are other circumstances in which it may become impossible for a taxpayer with split taxes to take related income into account in a subsequent year. For example, a taxpayer with taxes that were suspended

[38] Regs. §1.909-2T(b)(2)(v).

[39] *See* §909(d)(1) (defining a foreign tax credit splitting event as a circumstance in which ''related income is (or will be) taken into account. . .by a covered person''); *cf.* Regs. §1.909-6T(b)(3)(ii) (with respect to pre-2011 group relief splitter arrangements, ''The related income of a covered person is an amount equal to the shared loss, determined without regard to the actual amount of the covered person's earnings and profits.'').

[40] Regs. §1.909-6T(d)(1).


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under §909 might sell all of its stock of the covered person in a taxable transaction. If the gain exceeds the taxpayer's §1248 amount with respect to the stock, then the taxpayer would include all of the related income and the split taxes would be unsuspended. However, if the stock is sold at a loss, or if the §1248 amount exceeds the gain, then the taxpayer would lose the ability to include some or all of the related income. Suspended taxes would in effect become disallowed taxes. This result seems contrary to the intent of §909, but the Temporary Regulations do not provide any guidance that would ameliorate it. The 2012 NYSBA Report recommended retaining the disallowance of foreign taxes that would result in this scenario, but instead providing the taxpayer with an increase in the basis of the stock of the covered person, on the theory that the taxpayer made a contribution to the capital of the covered person by paying its tax on its behalf.[41]

The technical difficulties and harsh outcomes resulting from subsequent year losses and dispositions could be ameliorated to some extent by a return to the RIFO election. In essence, the RIFO election would allow taxpayers to undo the effects of a foreign tax credit splitting event by distributing from the recipient of the shared loss the E&P related to the suspended taxes, rather than by requiring the distribution of all the E&P of that entity. The RIFO election also would help ease the administrative and compliance burdens of the rule, eliminating the need to track §909 attributes indefinitely. One objection to the RIFO election is that it would permit taxpayers a windfall to the extent the distribution carries with it taxes paid by the distributing company directly in accordance with the normal operation of the §902 rules. This objection could be addressed by simply turning off the operation of §902 and allowing taxpayers to choose the intended result. The NYSBA offered another partial solution to these issues, recommending that the effects of the foreign tax credit splitting event in the loss-sharing context be undone if the U.S. combined income group that receives a loss in year 1 later shares a loss back to the U.S. combined income group that surrendered the loss in year 1.[42] The case for the RIFO election may be strongest in the loss-sharing context. Of the arrangements identified as foreign tax credit splitting events in the Temporary Regulations, loss-sharing splitter arrangements may be the only ones that taxpayers may inadvertently find themselves triggering by engaging in fairly routine foreign tax planning or for other benign reasons. Without changes to the Temporary Regulations, such taxpayers may find that undoing the effects of a foreign tax credit splitting event is an unduly costly proposition.

## CONCLUSION

Whether or not Congress had group relief in its sights when §909 was enacted, Treasury and the IRS carefully considered the extent to which §909 should apply to loss sharing. The policy lines drawn by the Temporary Regulations are sensible and better fulfill the purposes of the statute than does the Notice. Rather than identifying certain losses, such as those that arise from disregarded debt, as inherently questionable, the Temporary Regulations focus on whether the taxpayer has a choice to surrender losses to an affiliate in a manner that would separate taxes from E&P. Treasury and the IRS appear to have concluded that if the taxpayer in those circumstances utilized a loss surrender regime to separate taxes from E&P, the taxpayer's decision may have been motivated by U.S. foreign tax credit considerations. Such arrangements seem within the ambit of the policy concerns animating §909 even if they are arguably outside of §909's original intent and technical language.

[41] 2012 NYSBA Report, at 24–26.

[42] 2012 NYSBA Report, at 18–19.


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