Avoiding Foreign Tax Credit Splitting Events

New Code Sec. 909 suspends a credit for foreign taxes paid pursuant to a splitting event. This rule can apply, for example, to taxes paid by a parent corporation on income earned by its subsidiary. Taxpayers should determine whether they have splitting-event structures and consider taking steps to avoid the application of the new rule.

By way of background, a domestic corporation generally is entitled to claim a credit for the amount of any income tax it pays or accrues during the taxable year to any foreign country. A corporation is considered as paying or accruing a foreign tax that it is legally liable for under foreign law. A domestic corporation also can claim a credit for taxes it is deemed to have paid under Code Secs. 902 and 960. These include foreign income taxes paid or accrued by a foreign subsidiary that accompany earnings distributed as a dividend or earnings of the foreign subsidiary included in the gross income of the domestic corporation under subpart F.

Under certain circumstances, foreign law can impose tax liability on a corporation that does not earn the income on which the taxes are paid or accrued. This can arise, for example, where income is earned by an entity classified as a corporation for U.S. tax purposes, but treated as transparent for foreign tax purposes (a “reverse hybrid”). Foreign law would treat the owners as liable for tax on income derived by the entity. Similarly, separation of income from taxes can occur with foreign consolidated groups where foreign law imposes tax liability on income of the separate members at the parent level. Hybrid instruments also can have the effect of income being earned by one corporation and taxes paid by a different corporation from a U.S. perspective.

The law is clear that the person who is legally liable for income tax under foreign law is treated as the person paying or accruing the taxes for U.S. purposes, even if such person does not derive the income giving rise to the tax. In addition, prior to 2011, a taxpayer was permitted to immediately use such foreign taxes as a credit to reduce U.S. tax on other foreign source income (subject to limitations under Code Sec. 904). New Code Sec. 909 was enacted to address such “splitting events.” That section does not change the legal liability rule. Rather, if there is a foreign tax credit splitting event, the new rule suspends the ability of the person liable for the foreign taxes to take the taxes into account. This rule applies to foreign taxes paid directly by a U.S. corporation and foreign taxes paid by a foreign subsidiary (i.e., they are excluded for purposes of calculating deemed paid taxes). The suspended foreign taxes are released in the tax year in which the related income is subject to U.S. taxation or taken into account by the foreign corporation that is liable for the taxes.

There are significant issues in determining when foreign taxes cease to be suspended. What is the “related income”? When a parent pays taxes on income earned by a subsidiary, when is a dividend received by the parent...
from the subsidiary treated as the related income? Is related income considered as distributed under a LIFO, FIFO or pro rata concept? How is related income determined for hybrid instruments? Future guidance will likely provide a complex set of rules, and it may be that in certain circumstances foreign taxes subject to the new rule will be suspended indefinitely.

Therefore, a company might consider rearranging its international structures to eliminate foreign tax credit splitting events and avoid transactions that give rise to splitting events. Notice 2010-92, which provides guidance for pre-2011 taxes, identifies the following as splitting events: Reverse hybrid structures, certain foreign consolidated groups and loss sharing regimes, and certain hybrid instruments. The government has indicated that upcoming guidance will provide an expanded list of splitting events.

Disregarded entity structures may be used to eliminate certain splitting events without disrupting the foreign tax consequences. For example, an election may be filed to disregard subsidiaries of a parent of a foreign consolidated group that is liable for the foreign taxes on the group’s income (i.e., the parent and subsidiaries would be treated as a single corporation for U.S. purposes). Similarly, the owners of a reverse hybrid structure could be transferred to a new corporation, and the owners and reverse hybrid elect to be disregarded.

In addition, a splitting event can be eliminated by causing the income and taxes to be in the same entity. A group could opt not to elect consolidated treatment, or take the position that the group members are jointly and severally liable for income taxes. A reverse hybrid could convert to a local corporation and become subject to taxation at the entity level. Payments may be made currently on hybrid instruments. In addition, the government has indicated that it is considering finalizing proposed regulations providing that, under certain circumstances, foreign law would be considered to impose legal liability for tax on the person who is required to take the income into account for foreign income tax purposes (e.g., consolidated groups). To the extent these regulations provide for matching of foreign taxes and income, Code Sec. 909 should not apply to suspend the taxes.

It is noted that Code Sec. 909 generally should not apply to taxes on payments that are disregarded. For example, foreign taxes can be imposed on a payment (e.g., royalty or interest) made by a disregarded entity to its owner, or on a sale of assets by one disregarded entity to another disregarded entity owned by the same foreign person. Such foreign taxes should not be considered as paid pursuant to a splitting event, even though the payment or transaction does not result in U.S. income, because all income and taxes are, or will be, within a single entity for U.S. purposes (in other words, there is no “related income” to be taken into account under U.S. principles, and thus no splitting event occurs).

Code Sec. 909 guidance is expected soon, so a taxpayer may consider holding off on any material restructuring until more clarity is provided concerning what constitutes a splitting event (some structures that provide similar results may be outside the scope of the rules). Also, certain splitting-event structures may continue to be beneficial under the guidance (e.g., better than combining high and low-tax earnings pools of foreign subsidiaries).

Endnotes

1 Code Sec. 901(a), (b)(1).
2 M.D. Biddle, 573, 58 SCT 379; Reg. §1.901-2(b)(1).
3 If the members of the group are jointly and severally liable for the income tax under foreign law, then each member is considered as liable for the foreign tax on its portion of the group’s income. Reg. §1.901-2(b)(3).
5 IRB 2010-52, 916 (2010).
7 See Code Sec. 904(d)(2)(H) and Reg. §1.904-6(a)(1)(iv) for determining the foreign tax credit limitation category in which such taxes fall.

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