



International Tax

## United States Tax Alert

September 19, 2016

### Notice 2016-52 Introduces New Foreign Tax Credit Splitter Arrangements

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#### Background

On September 15, 2016, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued Notice 2016-52 (the "Notice"), announcing their intent to issue regulations under section 909 of the Internal Revenue Code (the Code) that will identify two new foreign tax credit splitter arrangements relating to section 902 corporations that pay foreign income taxes pursuant to foreign-initiated adjustments.<sup>1</sup> Final regulations (T.D. 9710) under section 909 were previously issued on February 9, 2015.

In general, the future regulations contemplated by the Notice will provide that a foreign tax credit splitter arrangement arises when, as a result of a "covered transaction," a section 902 corporation pays "covered taxes" during a tax year. The regulations will also provide that a foreign tax credit splitter arrangement results when a payor that is a section 902 corporation pays covered taxes during a tax year and the payor (or a predecessor of the payor) has made a "covered distribution."

#### Key Points for Consideration

- The regulations described in the Notice will apply to foreign income taxes *paid* on or after September 15, 2016.<sup>2</sup>
- The anticipated regulations would only apply if there is tax paid as a result of a foreign-initiated tax adjustment that results in

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<sup>1</sup> Unless otherwise indicated, all "section" references are to the Code, and all "Treas. Reg. §" references are to the Treasury Regulations promulgated or proposed thereunder respectively, by the Treasury or the IRS, both as in effect on the date of this Tax Alert.

<sup>2</sup> The effective date prescribed in the Notice is based on when the foreign income tax is paid, as opposed to accrued, and is not limited only to foreign-initiated adjustments arising from European Union (EU) state aid decisions.

an additional foreign income tax liability greater than \$10 million.

- Although the Notice only specifically addresses section 902 taxes, it provides that regulations will similarly defer section 901 foreign tax credits arising from taxes paid by a U.S. person pursuant to a foreign-initiated adjustment.

## Summary of the Rules

The Notice is intended to prevent U.S. multinational corporations from claiming foreign taxes arising from foreign initiated tax adjustments without repatriating the associated income.

When a section 902 corporation pays foreign income taxes in a taxable year after the taxable year to which the taxes relate, the section 902 pools of post-1986 foreign income taxes are adjusted in the taxable year in which the taxes are paid pursuant to section 905. However, rather than issue guidance under section 905, the provision which determines how certain subsequently paid foreign income taxes are taken into account, the Treasury determined that section 909 was the appropriate medium for addressing their concerns.

According to the Notice, section 909 was selected because it “is intended to prevent the separation of creditable foreign taxes from related income by deferring the right to claim credits until the related income is included in U.S. taxable income.”

### **Splitter Arrangements Arising from the Application of Section 905(c) to Successor Entities**

The first new splitter arrangement applies when the payor of the foreign income taxes arising from the foreign-initiated adjustment (the “covered taxes”) in the “splitter year” is different than the corporation than would have been the payor of the tax in the year to which it relates.<sup>3</sup> In such a case, and if the difference in payor is the result of a “covered transaction,” credits arising from such taxes will be deferred until the “related income” is included in U.S. taxable income.

- Covered taxes are foreign income taxes that: (1) are taken into account by adjusting the payor’s tax pools pursuant to section 905(c); and (2) result from a specified foreign initiated adjustment to the amount of foreign income tax accrued with respect to one or more prior taxable years.
- Specified foreign-initiated adjustment is a foreign-initiated adjustment (or series of related adjustments to more than one taxable year) that results in additional foreign income tax liability that is greater than \$10 million, regardless of whether such liability is actually paid in one or more taxable years (due, for example, to

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<sup>3</sup> The splitter year is the year in which the section 902 corporation payor pays the covered taxes. Notice, pg. 5.

an installment plan).<sup>4</sup>

- Covered transaction is “any transaction, or series of related transactions” that meet the following conditions:
  - (1) The transaction or series of related transactions results in covered taxes being paid by a payor that is a section 902 corporation and that *is not* the section 902 corporation that would have been the payor of the covered taxes (the predecessor entity) if the covered taxes had been paid or accrued in the relation-back year; *and*
  - (2) The predecessor entity (or a successor of the predecessor entity) was a covered person<sup>5</sup> with respect to the payor immediately before the transaction or series of related transactions, or, if the payor did not exist immediately before the transaction or series of related transactions, the predecessor entity (or a successor of the predecessor entity) was a covered person with respect to the payor immediately after the transaction or series of related transactions.”<sup>6</sup>

Unless the predecessor’s earnings and profits (“E&P”) were transferred to the payor pursuant to section 381(c)(2) or the taxpayer can show by clear and convincing evidence that the covered transaction was not engaged in with a principal purposes of separating the covered taxes from the predecessor’s post-1986 E&P that includes the E&P to which the covered taxes relate, the transaction will be treated as a splitter arrangement.

For purposes of this new splitter arrangement, related income is the sum of the portions of the predecessor’s E&P for each of the prior years that are:

- (1) Described in section 316(a)(2) (“section 316(a)(2) earnings”);
- (2) In the separate category or categories to which covered tax is assigned; and
- (3) 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 “adjusted foreign tax base”), regardless of which particular activities gave rise to the adjustment.<sup>7</sup>

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<sup>4</sup> Notice, pg. 6.

<sup>5</sup> A “covered person” is a person related to the payor of the foreign tax, as specified in section 909(d)(4).

<sup>6</sup> Notice, pg. 6-7.

<sup>7</sup> Notice, pg. 7. Principles of Treas. Reg. §1.909-6(d) apply when determining the amount of the predecessor’s related income that was transferred or taken into account by a section 902 shareholder or payor section 902 corporation. Notice, pg. 8.

## **Splitter Arrangements Arising from Distributions Made Before the Payment of Additional Tax Pursuant to Foreign-Initiated Adjustments**

The second arrangement arises when a payor pays covered taxes and that same payor has made a "covered distribution."<sup>8</sup>

- Covered Distribution is any distribution with respect to the payor's stock *to the extent* such distribution:
  - (1) Occurred in a taxable year of the payor to which the covered taxes relate or any subsequent taxable year up to and including the taxable year immediately before the taxable year in which the covered taxes are paid;
  - (2) Resulted in a distribution or allocation (for example, pursuant to section 1.312-10) of the payor's post-1986 undistributed earnings (but for this purpose not including [E&P] attributable to income effectively connected with the conduct of a trade or business within the United States or otherwise subject to tax under chapter 1 in the hands of the payor) to a section 902 covered person; *and*
  - (3) Was made with a principal purpose of reducing the payor's post-1986 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes."<sup>9</sup>

Distributions are presumed to meet the principal purpose requirement if the sum of all covered distributions (excluding the principal purpose requirement) is greater than 50 percent of the sum of (1) the payor's post-1986 undistributed earnings as of the beginning of the taxable year in which the covered taxes are paid, and (2) the sum of all covered distributions (excluding the principal purpose requirement).

This presumption is rebuttable only with clear and convincing evidence from the taxpayer that the distribution was not made with the principal purpose of reducing the undistributed earnings that include the earnings to which the covered taxes relate.

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<sup>8</sup> Covered distributions are treated as giving rise to a distribution of "initial related income" to the recipient on a pro rata basis and applying the principles of Treas. Reg. § 1.909-6(d)(3). Notice, pg. 12. The definition of initial related income is the same as the definition of related income under the first splitter arrangement. Recipients of initial related income are treated as taking into account related income in the taxable year of the covered distribution.

<sup>9</sup> Notice, pg. 10.

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