



TaxNewsFlash

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Notice 2016-52: Foreign tax credit related to foreign-initiated adjustments

The IRS today released an advance version of Notice 2016-52, adding two new categories of transactions to arrangements treated as “foreign tax credit splitter arrangements” under Code section 909. The transactions involve distributions of earnings by, or restructurings of certain foreign corporations (“section 902 corporations”) in order to separate earnings from foreign taxes paid in a later year as a result of a foreign initiated adjustment that results in an assessment of additional tax on prior year earnings.

The amount of additional foreign income taxes paid must be greater than \$10 million.

[Notice 2016-52](#) [PDF 64 KB] applies to foreign income taxes paid on or after September 15, 2016.

KPMG observation

Although not expressly limited to additional taxes arising from EU state aid decisions, Notice 2016-52 cites the EU state aid cases as an example of a situation in which a foreign-initiated adjustment may arise. The Treasury Department and IRS, however, have not determined that taxes imposed as a result of a state aid decision are creditable foreign taxes. Notice 2016-52 expressly states that it does not address whether “...payments made pursuant to any particular foreign-initiated adjustment, including those arising under EU State aid law, qualify as payments of creditable foreign income taxes.” The notice also expressly does not address whether taxes paid by a U.S. person pursuant to a foreign-initiated adjustment to the tax liability of a section 902 corporation are creditable under section 901.

Notice 2016-52 appears to be aimed at a relatively small number of taxpayers subject to large state aid disputes, but also has broader applicability to foreign tax redeterminations with respect to section 902 taxes paid in prior years.

Background

Under section 905(c), an additional assessment of foreign income taxes for a prior tax year generally requires a redetermination of prior year foreign tax credits and U.S. tax liability. If the additional foreign taxes are the liability of a section 902 corporation (“section 902 taxes”), proposed (and expired temporary) regulations generally provide for adjustments to post-1986 earnings and taxes in the year of the additional assessment—in lieu of filing amended returns for the years to which the additional taxes relate. When additional section 902 taxes are assessed more than two years after the close of the tax year to which they relate, section 905(c)(2)(B) mandates that they be accounted for through pooling adjustments in the later year. Neither the Code nor the proposed or temporary regulations address how to account for foreign taxes paid by one section 902 corporation that is different from the section 902 corporation that would have paid such tax if it had been accrued in the year to which it relates.

Section 909 (enacted in 2010) attempts to mandate the “matching” of foreign tax credits and related income by suspending foreign taxes and disallowing foreign tax credits until the related earnings are taken into account by the same taxpayer or, in the case of taxes paid by a section 902 corporation, by such section 902 corporation or certain domestic corporate shareholders. Final regulations issued in 2012 provide an exclusive list of arrangements that will be treated as foreign tax credit splitter arrangements subject to section 909. The preamble to the final regulations leaves open the possibility that additional transactions may be added.

For each type of splitter arrangement in the section 909 regulations, the IRS defines the foreign taxes that are “split taxes” and thus suspended and the amount of “related income” that must be received by the entity with the split taxes or the ultimate U.S. shareholder for the split taxes to become creditable.

Foreign-initiated splitter arrangements

Notice 2016-52 adds two new categories of splitter arrangements—referred to as “foreign-initiated adjustment splitter arrangements”—that will be added to the section 909 regulations. Both involve transactions undertaken to separate a section 902 corporation’s earnings from foreign taxes imposed on those earnings in a subsequent year.

Unlike the splitter arrangements described in the final section 909 regulations, the new splitter arrangements apply to foreign taxes paid with respect to pre-2011 years.

Change in ownership splitter

The first “foreign-initiated splitter arrangement” arises from the combination of a change in ownership structure with an additional assessment of foreign tax related to

years prior to the ownership change. Regulations will provide that a splitter arrangement arises when, as a result of a “covered transaction,” a section 902 corporation pays “covered taxes” in a later year (the “splitter year”). For this purpose, **covered taxes** are foreign income taxes that:

- Are taken into account through adjustments to the payor’s post-1986 undistributed earnings and taxes pools in the year paid, and
- Result from a “specified foreign-initiated adjustment” to the amount of foreign income taxes paid in one or more prior years

A specified foreign-initiated adjustment is a foreign-initiated adjustment (or series of adjustments) for one or more tax years that results in a total additional tax liability of **greater than \$10 million**.

A **covered transaction**, stated generally, is a transaction or series of transaction that results in a different section 902 corporation (the successor) paying the covered taxes than the section 902 corporation that would have paid those taxes in the year or years to which they relate (the predecessor), if the section 902 corporations are or were related/covered persons as defined in Reg. section 1.909-1(a)(4). Exceptions are provided for transactions in which the successor also succeeds to the earnings and profits of the predecessor under section 381(c)(2), and when the taxpayer can demonstrate **by clear and convincing evidence** that the transactions or series of transactions did not have a principal purpose of separating covered taxes from undistributed earnings of the predecessor to which they relate.

Related income for this purpose is the sum of the predecessor’s earnings and profits for each relation-back year in the same section 904(d) category to which the covered taxes are assigned and that are attributable to activities that gave rise to income included in the base on which the tax was imposed. Split taxes are taxes that related to the predecessor’s income that was not transferred in the covered transaction, reduced by certain amounts that would not be split taxes because a section 902 shareholder took related income into account in a prior year.

Distribution splitter

The second type of foreign-initiated splitter arrangement arises from distributions made before (and in anticipation of) the payment of additional foreign taxes pursuant to a foreign-initiated adjustment. Regulations will provide that a splitter arrangement arises when a payor section 902 corporation pays covered taxes (as defined above) during a tax year and the corporation has made a “covered distribution.”

A covered distribution is any distribution with respect to the payor section 902 corporation’s stock to the extent the distribution:

- Occurred in a tax year to which the additional taxes relate or a subsequent year prior to the tax year in which the additional taxes are paid,

- Resulted in a distribution or allocation of post-1986 undistributed earnings (other than effectively connected income) to a section 902 corporation that is a covered person under the section 909 regulations, and
- Was made with a principal purpose of reducing the payor's post-1986 undistributed earnings in advance of the payment of covered taxes

A distribution is presumed to meet the principal purpose test if the sum of all covered distributions is greater than 50% of the sum of post-1986 undistributed earnings at the beginning of the year in which a covered tax is paid and the total of all distributions that would be covered distributions without regard to the principal purpose test. The presumption may be rebutted by **clear and convincing evidence**.

Each distribution is treated as a distribution of related income on a proportionate basis. See Reg. section 1.909-6(d)(3). Split taxes are covered taxes multiplied by a fraction, the numerator of which is total related income at the beginning of the splitter year and the denominator of which is the payor's initial related income.

Request for comments

The Treasury Department and IRS request comments on the rules described in Notice 2016-52, and specifically on two issues.

- First, whether the transactions treated as splitter arrangements under Notice 2016-52 would be more appropriately addressed under the section 905(c) regulations by providing that additional payments of tax must be accounted for through adjustments to the pools of post-1986 earnings and taxes of section 902 corporations that are not the same entity that actually pays the tax.
- Second, whether an objective test would be preferable to the subjective principal purpose tests provided and if so, what types of objective tests could be used.

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