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presents

Foreign Tax Credits for U.S. Taxpayers: Dealing With New Restrictions

Preparing for Tough Limits on Credit Use and Repeal of 80/20 Rules

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Fred Corso, Tax Director, **Marcum LLP**, Boston

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LaVonda Napka, **Thompson Hine**, Cleveland

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Thursday, October 7, 2010

The conference begins at:

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12 pm Central

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Foreign Tax Credits For U.S. Taxpayers: Dealing With New Restrictions Webinar

Oct. 7, 2010

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Prohibition On Foreign Tax Credit-Splitting

LaVonda Napka, Thompson Hine

Preventing Splitting Foreign Tax Credits From Related Foreign Income

■ Background

▣ Technical taxpayer rule

- ▣ The technical taxpayer is the person by whom tax is considered paid for purposes of sections 901 and 903.
- ▣ *Biddle v. Commissioner*, 302 U.S. 573 (1938).
 - ▣ Supreme Court held that the person who paid the foreign income taxes, as determined under U.S. tax principles, is entitled to the foreign tax credit.
- ▣ Treas. Reg. § 1.901-2(f)(1) states in part:

“The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax.”

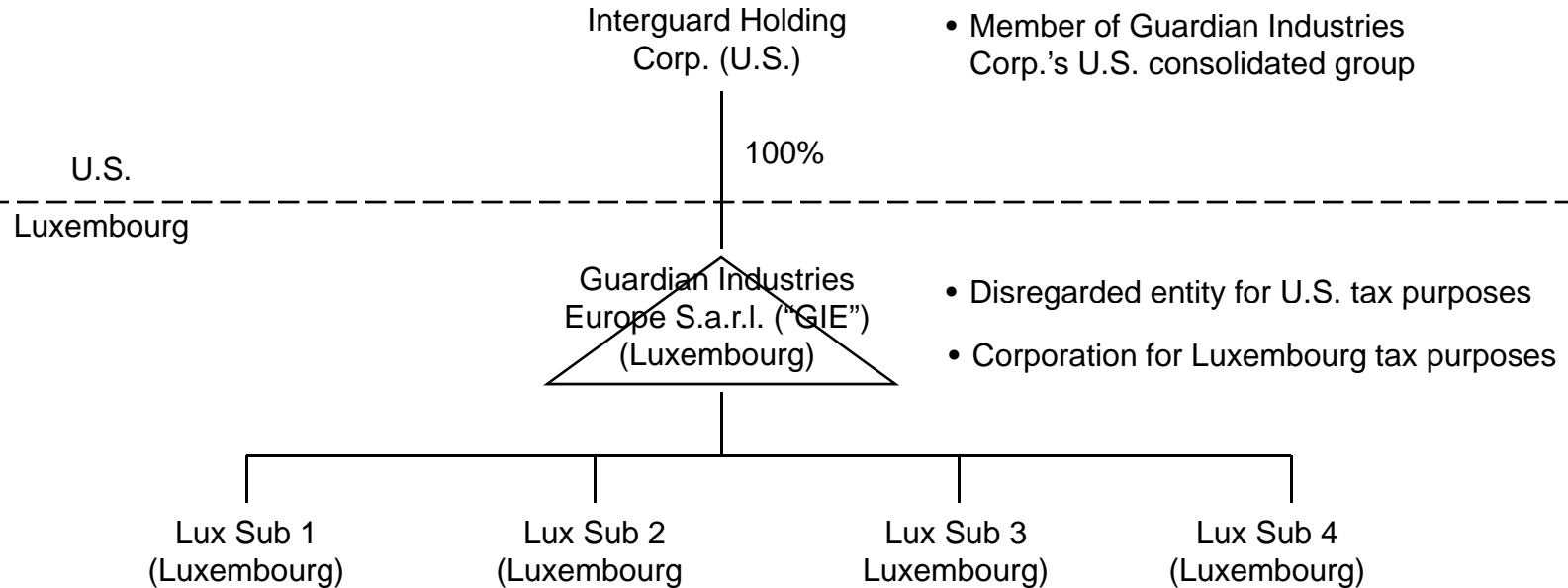
Preventing Splitting Foreign Tax Credits From Related Foreign Income (Cont.)

- The technical taxpayer rule has provided opportunities for taxpayers to split off foreign income taxes from related foreign income.
- In Prop. Reg. § 1.901-2(f) (issued 8/4/2006), IRS proposed amending the technical taxpayer rule to address certain splitting arrangements. Prop. Reg. § 1.901-2(f)(1)(i) states in part:

“In general, foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes ...”

Example Of Splitting Arrangement

- Guardian Industries Corp. v. U.S., 477 F.3d 1368 (Fed. Cir. 2007).



- Lux Subs 1-4 are corporations for both U.S. and Luxembourg tax purposes.

Guardian Industries (Cont.)

- For 2001, GIE filed a consolidated Luxembourg tax return on behalf of itself and Lux Subs 1-4.
- GIE paid Luxembourg income taxes on its income and on the income of Lux Subs 1-4.
- Lux Subs 1-4 did not dividend their 2001 income to GIE.
- The Guardian Industries U.S. consolidated group claimed Sect. 901 credit on its 2001 Form 1120 for Luxembourg income taxes GIE paid on the income of Lux Subs 1-4, even though such income was not included on the 2001 Form 1120 for the Guardian Industries U.S. consolidated group.

- Federal Circuit held:
 - ▣ Under Luxembourg tax law, GIE was the person liable for the Luxembourg income tax on the income of Lux Subs 1-4 (no joint and several liability, either).
 - ▣ The technical taxpayer rule of Treas. Reg. § 1.901-2(f)(1) looks at which entity bears the imposition of the foreign income tax, not which entity earned the foreign income.
 - ▣ The Guardian Industries U.S. consolidated group was entitled to the Sect. 901 credit.

What The Act Does

- Act adds new Sect. 909, which establishes a matching rule.
- Under the matching rule, if a “foreign tax credit splitting event” occurs:
 - ▣ The taxpayer may not take into account the split-off foreign income taxes for U.S. tax purposes until the taxable year in which the taxpayer takes into account the related foreign income for U.S. tax purposes.
 - ▣ With respect to foreign income taxes paid or accrued by a foreign corporation for which a U.S. corporate shareholder is eligible for a Sect. 902 credit, the split-off foreign taxes may not be taken into account for purposes of sections 902, 960 or 964(a) until the taxable year in which such foreign corporation or such U.S. corporate shareholder takes into account the related foreign income for U.S. tax purposes.

What The Act Does (Cont.)

- The matching rule essentially suspends the foreign tax credit until the related income is repatriated to the U.S.
 - ▣ Generally, those foreign income taxes affected by the matching rule are not taken into account for any U.S. tax purpose. Such foreign income taxes are first taken into account, and treated as paid or accrued, in the year in which the related foreign income is taken into account.

What The Act Does (Cont.)

- Application to partnerships and other entities:
 - ▣ New Sect. 909's matching rule is applied at the partner level.
 - ▣ Except as otherwise provided by the IRS, a similar rule applies to S corporations and trusts.
 - ▣ JCT explanation provides that the IRS may issue regulations to establish the applicability of new Sect. 909 to a RIC that elects under I.R.C. §853 for the foreign income taxes it pays to be treated as creditable to its shareholders under I.R.C. §901.

What The Act Does (Cont.)

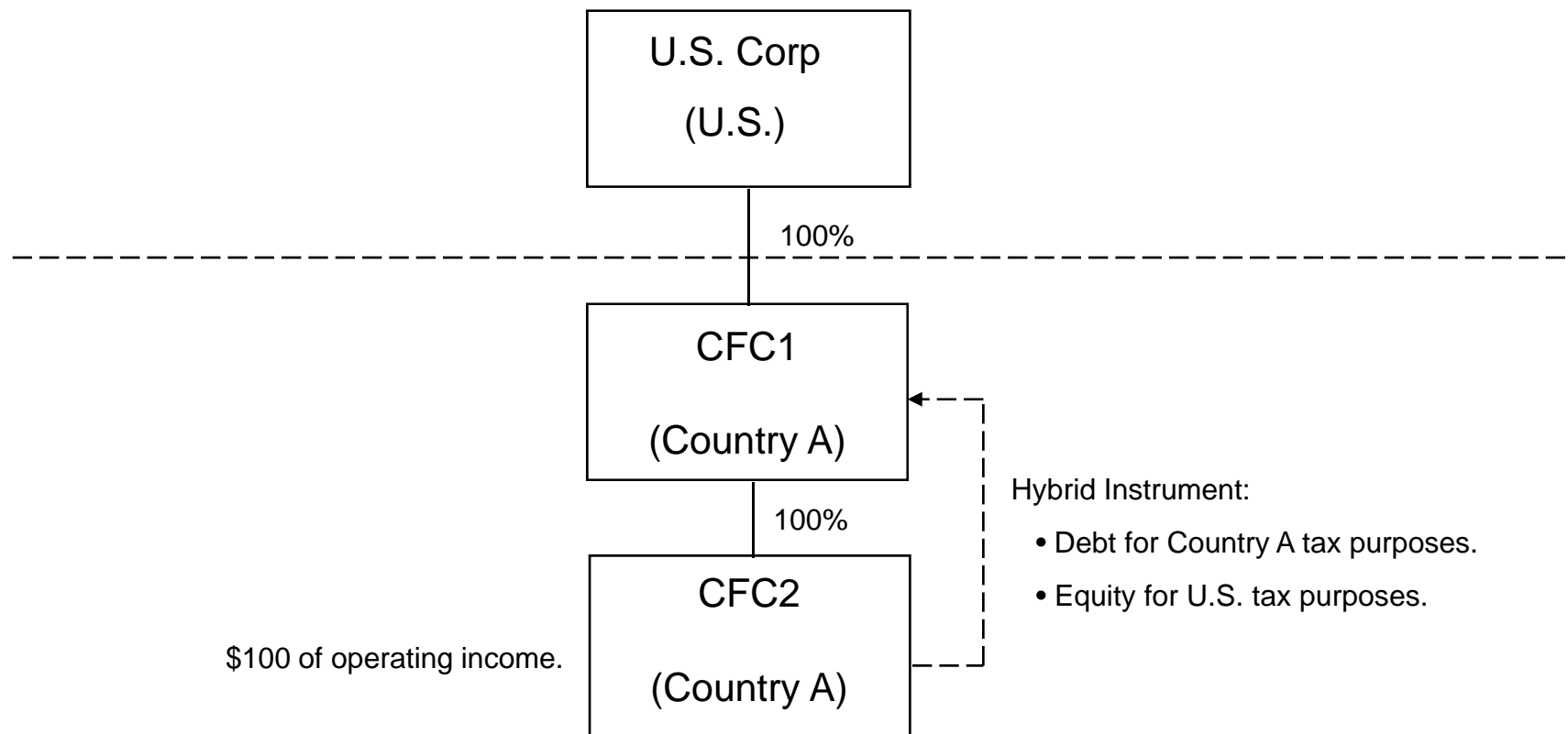
- ▣ A “foreign tax credit splitting event,” with respect to a foreign income tax, is one in which the related foreign income is or will be taken into account by a “covered person.”

- ▣ A “covered person” is a person who is related to the person who paid or accrued the split-off foreign income tax (the “payor”) in any of the following ways:
 - ▣ Any entity in which the payor holds, directly or indirectly, at least a 10% interest (determined by vote or value);
 - ▣ Any person who holds, directly or indirectly, at least a 10% interest (determined by vote or value) in the payor;
 - ▣ Any person who bears a relationship to the payor described in sections 267(b) or 707(b); or
 - ▣ Any other person specified by the IRS.

What The Act Does (Cont.)

- The IRS may issue regulations or other guidance “as is necessary or appropriate to carry out the purposes of [new Sect. 909]”.
 - ▣ Exceptions from application of new Sect. 909
 - ▣ Guidance as to the property application with respect to hybrid instruments

JCT Hybrid Instrument Example



JCT Hybrid Instrument Example (Cont.)

- CFC2 issues a hybrid instrument to CFC1.
 - ▣ Treated as a debt for Country A tax purposes, but as equity for U.S. federal income tax purposes

- Under the terms of the instrument, CFC2 accrues (but does not pay currently) interest to CFC1 equal to \$100.
 - ▣ CFC2 has no income, for Country A tax purposes.
 - ▣ \$100 operating income less \$100 interest deduction = \$0
 - ▣ CFC1 has \$100 of interest income subject to Country A tax, at a rate of 30%.
 - ▣ For U.S. income tax purposes, CFC2 has \$100 income, while CFC1 has paid \$30 of foreign income tax.

JCT Hybrid Instrument Example (Cont.)

- Under new Sect. 909, the related foreign income with respect to the \$30 of foreign taxes paid by CFC1 is the \$100 of earnings and profits of CFC2.
 - ▣ Thus, U.S. Corp. would not be permitted a Sect. 902 foreign tax credit with respect to the \$30 of foreign taxes paid by CFC1 until the taxable year in which the related income is taken into account for U.S. federal income tax purposes, either by CFC1 or U.S. Corp.

What The Act Does (Cont.)

- Effective dates of new Sect. 909
 - ▣ Generally effective for foreign income taxes paid or accrued in taxable years beginning after Dec. 31, 2010
 - ▣ However, for foreign income taxes (a) paid or accrued by a foreign corporation for which a U.S. corporate shareholder is eligible to take a Sect. 902 foreign tax credit and (b) not deemed paid under Sect. 902(a) or 960 on or before Dec. 31, 2010, new Sect. 909 is effective for taxable years beginning on or before Dec. 31, 2010, but only for purposes of applying sections 902 and 960 with respect to periods after such date.

Practical Considerations

- New Sect. 909 is much broader than Prop. Reg. §1.901-2(f)(1).
- Definition of “related income”
- Uncertainty as how to take suspended taxes into account in differing scenarios
 - ▣ JCT anticipates guidance as to the proper application of new Sect. 909 in cases of disregarded payments, group relief, other similar arrangements, or the liquidation of a “covered person.”

Covered Assets And Sect. 304 Redemptions

Fred Corso, Marcum LLP

Stephen Feldman, Morrison & Foerster

Covered Asset Acquisitions

Introduction

The new law introduces Code Sect. 901(m).

- In general, U.S. taxpayers are subject to federal income tax on their worldwide income.
- Relief from double-taxation is available through the use of the foreign tax credit (FTC).
- Sect. 901(m) seeks to mitigate perceived abuses of the FTC as a result of the mechanics of the FTC computation.

Covered Asset Acquisitions (Cont.)

In general

Certain elections or transactions create additional asset basis of foreign assets for U.S. income tax purposes, including:

- A qualifying stock purchase of a foreign corporation (or domestic corporation with foreign assets) for which a Sect. 338 election is made;
- Acquisition of an interest in a partnership that holds foreign assets and for which a Sect. 754 election is in effect; or
- Certain other transactions involving an entity classification (“check-the-box”) election.

Covered Asset Acquisitions (Cont.)

Consequences under old law

- Basis of the assets of the foreign target or underlying assets of the partnership is increased for U.S. tax purposes, but not for purposes of the relevant foreign jurisdiction.
- Increased basis thus increases depreciation, amortization and depletion (or merely overall basis) for purposes of U.S. taxable income and E&P.
- No corresponding adjustment for foreign jurisdiction's tax purposes
- Disparity in basis results in a permanent difference between (a) foreign taxable income, and (b) U.S. taxable income and E&P.
- General result: Foreign source income for U.S. purposes is generally lower than the taxable income in the foreign jurisdiction and therefore carries with it a proportionately higher creditable foreign tax.

Covered Asset Acquisitions (Cont.)

Consequences under new law

The new law attempts to remove the “artificial” disparity that results in the proportionately higher creditable foreign tax that carries out with the distribution of the associated foreign source income.

Disqualification of a portion of the foreign income tax related to relevant foreign assets in a covered asset acquisition, for purposes of:

- Direct foreign tax credit (Sect. 901) where foreign income taxes paid by U.S. taxpayer, and
- Indirect foreign tax credit (Sect. 902) where foreign income tax paid by “Section 902 corporation”

Covered Asset Acquisitions (Cont.)

Definition of a “covered asset acquisition”

- A qualified stock purchase (as defined in Sect. 338(d)(3)) to which Sect. 338(a) applies
- Any transaction which is treated as the acquisition of assets for U.S. tax purposes, and as the acquisition of stock (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction
- Any acquisition of an interest in a partnership that has an election in effect under Sect. 754
- To the extent provided by the secretary, any other similar transaction

Covered Asset Acquisitions (Cont.)

Definition of “disqualified portion”

The disqualified portion of foreign income tax with respect to a covered asset acquisition is the ratio, expressed as a percentage, of:

(1) The aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets,

Divided by

(2) The income on which the foreign income tax is determined*

* Note: If the taxpayer fails to substantiate the income, the income is determined by dividing the amount of foreign income tax by the highest marginal tax rate applicable to the income in the relevant jurisdiction.

Covered Asset Acquisitions (Cont.)

Additional terms and rules:

- “Basis difference” is the excess of the adjusted basis of each asset immediately after the covered asset acquisition:

Adjusted basis immediately after covered asset acquisition

Less: Adjusted basis immediately before covered asset acquisition

Basis difference (NOTE: May be positive or negative amount)

- Relevant adjusted tax basis is the basis used for U.S. tax purposes (e.g., generally straight line cost recovery for controlled foreign corporations)*
- In a year of disposition of any relevant foreign asset:
 - Basis difference is the excess of the basis difference of the asset over the aggregate basis difference allocated to prior years.
 - No basis difference with respect to the asset shall be allocated to a future tax year.

* NOTE: IRS may issue regulations as to when basis as determined under law of relevant foreign jurisdiction may be acceptable.

Covered Asset Acquisitions (Cont.)

Additional terms and rules (Cont.)

- “Relevant foreign asset” is, with respect to any covered asset acquisition, any asset (including goodwill, going concern value or other intangible) with respect to the acquisition if income, deduction, gain or loss attributable to the asset is taken into account in determining foreign income tax.
- “Foreign income tax” means any income, war profits or excess profits tax paid or accrued to any foreign country or to any U.S. possession.
- To the extent that a foreign tax credit is disallowed, the disqualified portion is allowed as a deduction to the extent otherwise deductible.

Covered Asset Acquisitions (Cont.)

Illustration per Joint Committee report

To illustrate, assume USP, a domestic corporation, acquires 100 percent of the stock of FT, a foreign target organized in Country F with a “u” functional currency, in a qualified stock purchase for which a [section 338\(g\)](#) election is made. The tax rate in Country F is 25 percent. Assume further that the aggregate basis difference in connection with the qualified stock purchase is 200u, including: (1) 150u that is attributable to Asset A, with a 15-year recovery period for U.S. tax purposes (10u of annual amortization); and (2) 50u that is attributable to Asset B, with a 5-year recovery period (10u of annual depreciation). In each of years 1 and 2, FT's taxable income is 100u for foreign tax purposes and FT pays foreign income tax of 25u (equal to \$25 when translated at the average exchange rate for the year). As a result, the disqualified portion of foreign income tax in each of years 1 and 2 is \$5 ((10u + 10u of allocable basis difference / 100u of foreign taxable income) x \$25 foreign tax paid).

In year 3, FT's taxable income is 140u, 40u of which is attributable to gain on the sale of Asset B. FT's Country F tax is 35u (equal to \$35 translated at the average exchange rate for the year). Accordingly, the disqualified portion of its foreign income taxes paid is \$10 ((40u (including 10u of annual amortization on Asset A and 30u attributable to disposition of Asset B) of allocable basis difference / 140u of foreign taxable income) x \$35 foreign tax paid).

Covered Asset Acquisitions (Cont.)

Illustration per Joint Committee Report (Cont.)

	Total	Year 1	Year 2	Year 3
	Allocable	Allocable	Allocable	Allocable
	Basis	Basis	Basis	Basis
Description	Difference	Difference	Difference	Difference
Asset A	\$ 150	\$ 10	\$ 10	\$ 10
Asset B	\$ 50	\$ 10	\$ 10	\$ 30
Total Difference (X)	\$ 200	\$ 20	\$ 20	\$ 40
Taxable Income (Y)	n/a	\$ 100	\$ 100	\$ 140
Disqualified Portion % (X)/(Y)	n/a	20%	20%	29%
Foreign Tax	n/a	\$ 25	\$ 25	\$ 35
Disqualified Portion %	n/a	20%	20%	29%
Disqualified Foreign Tax	n/a	\$ 5	\$ 5	\$ 10

Covered Asset Acquisitions (Cont.)

What does it mean in practice?

- Increased effort to obtain/create U.S. tax basis records for foreign operations
- Greater complexity of the foreign tax credit calculation
- More recordkeeping requirements with respect to the foreign tax credit
- Additional work in connection with financial statement income tax provisions
- Additional considerations in connection with operational restructurings that are not tax-motivated
- Additional considerations for even the most basic changes of tax classification (e.g., check-the-box that qualifies as Sect. 331 transaction)
- **Keep in mind:** There are still important reasons to consider such elections as a Sect. 338(g) election (e.g., fresh start for foreign target's E&P).

Covered Asset Acquisitions (Cont.)

Effective date

- Generally effective for covered asset acquisitions occurring after Dec. 31, 2010
- Later effective date for certain covered transactions between unrelated parties:
 - Made under written agreement that is binding on Jan. 1, 2011, and at all times thereafter;
 - Described in a ruling request submitted to the IRS before July 30, 2010; or
 - Described before Jan. 2, 2011, in a public announcement or in a filing with the SEC.

Background: Sect. 304

Sect. 304 governs so-called redemptions through the use of related corporations. The general purpose is to police transactions in the form of a stock purchase that may be equivalent to a dividend.

Under Sect. 304(a), if one corporation (the “acquiring corporation”) purchases stock of a related corporation (the “issuing corporation”) in exchange for property (e.g., cash), the transaction generally is recharacterized as a redemption.

Under Sect. 304(b)(1), the determination of whether the redemption is treated as a sale or exchange, or a Sect. 301 distribution (i.e., a dividend to the extent of earnings and profits is made by applying Sect. 302 with reference to the stock of the issuing corporation; taking into account the constructive ownership rules of Sect. 318 but without regard to the 50% limitation in Sect. 318(a)(2)(C) and 318(a)(3)(C).

Background: Sect. 304 (Cont.)

There are two basic patterns of Sect. 304 transactions: (1) brother-sister, and (2) subsidiary acquisitions.

In a brother-sister acquisition (Sect. 304(a)(1)), one subsidiary (Sub 2) acquires stock of its sister subsidiary (Sub 1) from the parent for cash or property. (*See Diagram 1, later in this section*)

In a subsidiary acquisition (Sect. 304(a)(2)), Sub 2 acquires stock of its immediate parent, Sub 1, from Sub 1's shareholder, parent, for cash or property. (*See Diagram 2, later in this section*)

Under Sect. 304(b)(2), both the amount and the source of a dividend in any Sect. 304 transaction is determined as if the cash or property were distributed by the acquiring corporation (i.e., Sub 2) to the extent of its E&P, and then by the issuing corporation (i.e., Sub 1) to the extent of its E&P.

To the extent the dividend is sourced from the E&P of the acquiring corporation (i.e., Sub 2), the transferor is considered to receive the dividend directly from the acquiring corporation.

Background: Sect. 304 (Cont.)

Special rules apply if the acquiring corporation is foreign. Under Sect. 304(b)(5) (prior to amendment by the act), E&P of the foreign acquiring corporation is taken into account only to the extent:

- (i) Attributable to stock of the acquiring corporation owned by a corporation or individual which was (I) a “United States shareholder” (within the meaning of Sect. 951(b)) of the acquiring corporation, and (II) the transferor (or related person under Sect. 267(b) or 707(b)); and
- (ii) Accumulated during the period or periods such stock was owned by such person while the acquiring corporation was a controlled foreign corporation (CFC).

This rule was adopted to prevent a U.S. taxpayer from claiming foreign tax credits in a Sect. 304 transaction where a direct dividend from a foreign acquiring corporation to a foreign ultimate parent would not have resulted in any foreign tax credits. Example: FP owns Sub 1 (U.S.) and Sub 2 (foreign) and Sub 1 owns Sub 3. Sub 2 buys Sub 3 from Sub 1.

Background: Sect. 304 (Cont.)

Example 1: Prior to enactment of P.L. 111-226 (the act), in a foreign subsidiary acquisition (*see Diagram 2, later in this section*), if Sub 2 had sufficient E&P, then the entire dividend would be sourced from its E&P, and parent would be considered to receive the entire dividend directly from Sub 2 (a foreign corp.) and not from Sub 1 (a U.S. corp.). As a result, no U.S. withholding tax would apply to the dividend, and the E&P of Sub 2 (a CFC) would permanently escape U.S. tax.

Example 2: Prior to the act, in a brother-sister ownership structure (*see Diagram 1, later in this section*), if Sub 2 bought stock of Sub 1 from parent, no E&P of Sub 2 could be taken into account because Sub 2 is not a CFC. So, only E&P of Sub 1 would be taken into account, which could result in U.S. withholding tax.

So, instead, it is better for Sub 2 to simply pay a foreign source dividend directly to parent.

New Law

Sect. 215(a) of the act adds a new limitation on the ability to take into account E&P of a foreign acquiring corporation, which is designed to prevent the foreign acquiring corporation's E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation.

Under new Sect. 304(b)(5)(B), if more than 50% of the dividends arising from an acquisition would (without taking into account the new provision) neither (1) be subject to U.S. tax in the year in which the dividend arises, nor (2) be includible in the E&P of a CFC, then, in determining the amount and source of the dividend, none of the E&P of the foreign acquiring corporation is taken into account, and only the E&P of the issuing corporation is taken into account.

The provision is effective for acquisitions after the date of enactment of the act (Aug. 10, 2010).

New Law (Cont.)

Observations

The new provision is aimed at example illustrated in Diagram 2, later in this section.

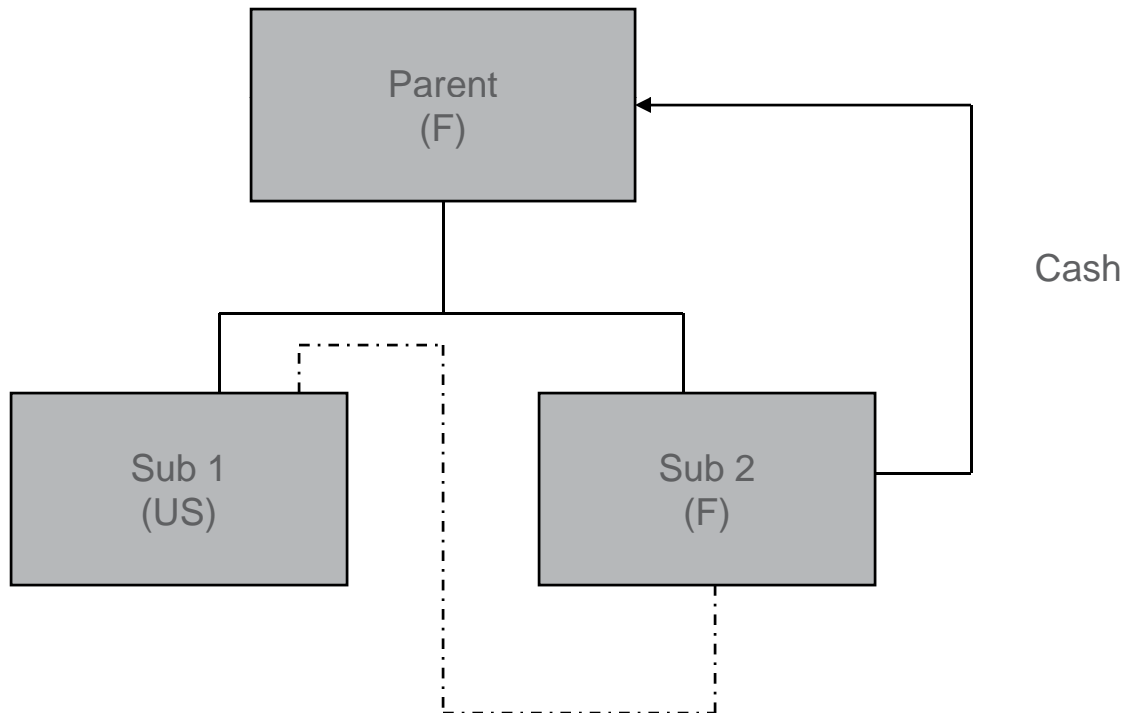
The new provision has a cliff effect. Once the 50% threshold is exceeded, none of the E&P of the acquiring foreign corporation is taken into account.

The JCT report states that it is anticipated that regulations will provide rules to prevent the avoidance of the provision, including through the use of partnerships, options, or other arrangements to cause a foreign corporation to be treated as a CFC.

The new statute effectively shuts down use of Sect. 304 to reduce U.S. tax on earnings of a foreign subsidiary in a sandwich structure, where an ultimate foreign parent owns a foreign subsidiary indirectly through a U.S. corporation.

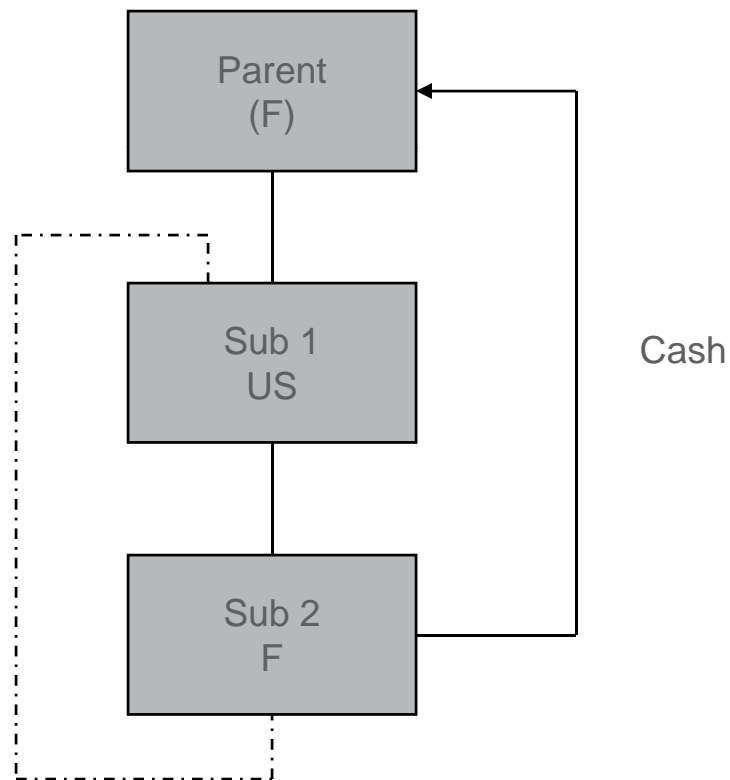
Sect: 304: Brother-Sister Acquisition

Diagram 1: Sub 2 acquires stock of Sub 1 from parent for cash.



Sect. 304: Foreign Subsidiary Acquisition

Diagram 2: Sub 2 acquires stock of Sub 1 from parent for cash.



Anti-Sect. 956 Hopscotch Rules And Select International Tax Provisions

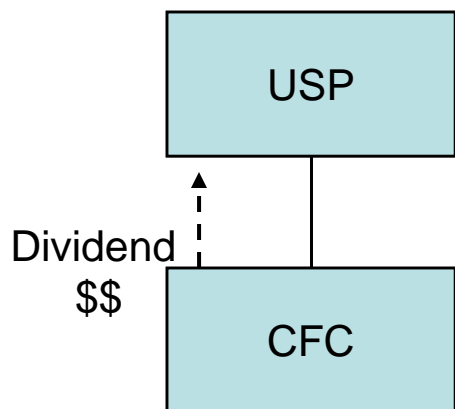
**William Winter, Morris, Manning &
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Sect. 956 - Background

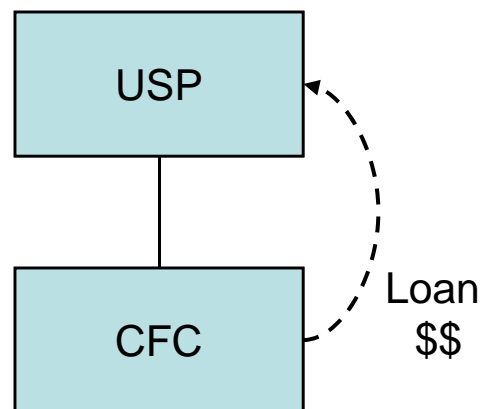
①

Problem:
CFC has cash, wants
to avoid dividend



②

Solution:
CFC loans cash to
benefit US parent
without dividend

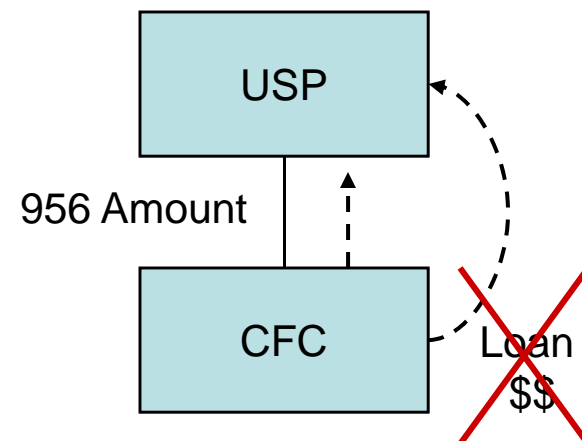


Other Solutions:

- CFC buys US real estate & leases to parent
- CFC buys IP & licenses to parent
- CFC serves as guarantor for debts of parent

③

Sect. 956:
Requires dividend
treatment





Sect. 956 - General Rule

Sect. 956 amount

An amount of income to be included by any “United States shareholder” of a CFC for a given taxable year, equal to the lesser of:

(1) The excess (if any) of

- Such shareholder’s pro rata share of the average of the amounts of “U.S. property” held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year, over
- The amount of earnings and profits described in Sect. 959(c)(1)(A) with respect to such shareholder; OR

(2) Such shareholder’s pro rata share of the applicable earnings of such CFC.

- Generally, current and accumulated E&P less distributions and previously taxed income (PTI)
- If accumulated EP is negative, applicable EP is current EP less current distributions and PTI.



Sect. 956 – U.S. Property

The term “U.S. property” means any property acquired after Dec. 31, 1962, that is:

Tangible property situated in the U.S.

Stock of a domestic corporation

An obligation of a U.S. person

Loan from a CFC to its parent

- Direct pledge or guarantee by CFC (or offer to buy note at maturity)
- Indirect pledge or guarantee by CFC (assets of CFC serve as indirect security for obligation)
- Pledge of 66 2/3% of CFC stock with shareholder restriction on asset disposition



Sect. 956 – U.S. Property (Cont.)

Any right to use intellectual property in the U.S., if such intellectual property is:

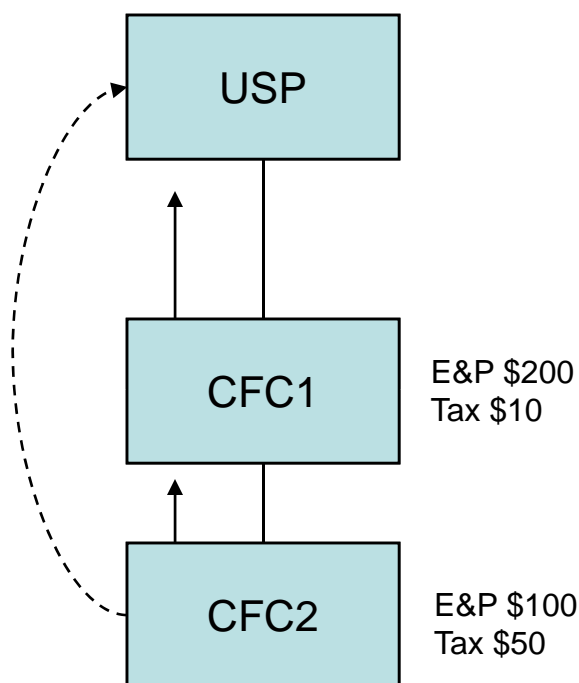
- A patent or copyright, an invention, model or design (whether or not patented), a secret formula or process, or any other similar property right; and
- Such right is acquired or developed by the CFC for use in the U.S.

A trade or service receivable that is acquired (directly or indirectly) from a related person who is a U.S. person, and the obligor under such receivable is a U.S. person.

NOTE: Sect. 956 amount is based on the adjusted basis of U.S. property as determined for computing E&P (reduced by any liability to which the property is subject).



Beneficial Use Of Sect. 956 (Before The Education Jobs Act)



Dividend or Loan?

If cash is repatriated as a dividend in the year earned, then USP:

- Would include the dividend as taxable income of USP
- Would be entitled to a Sect. 960 deemed paid foreign tax credit
- In calculating the FTC, the low tax E&P would blend with the higher-taxed E&P, potentially causing a lower overall deemed paid FTC for USP.
- Withholding tax may apply to dividend

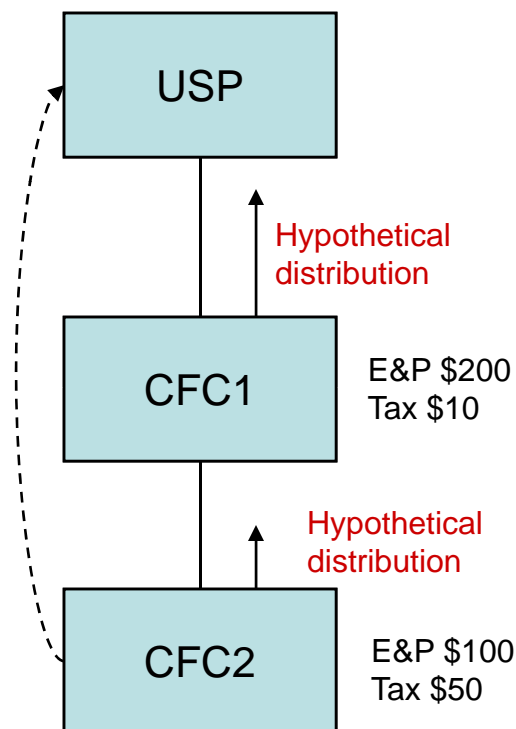
If cash is repatriated as a loan from CFC2 to USP:

- Sect. 956 requires inclusion of CFC2 E&P, to the extent of the loan amount.
- USP would base FTC calculation solely on CFC2 higher-taxed income, maximizing FTC from CFC2.
- Interest expense deductible by USP

Anti-Sect. 956 Hopscotch

- Added Sect. 960(c) to the Code for acquisitions of U.S. property after Dec. 31, 2010
- The amount of foreign taxes deemed paid in each separate category is separately determined by comparing the foreign taxes deemed paid with respect to the U.S. shareholder's Sect. 956 inclusion to the hypothetical amount of foreign taxes deemed paid as computed under the provision.
- The hypothetical credit is the amount of foreign taxes deemed to have been paid if cash in an amount equal to the Sect. 956 inclusion had been distributed up from the foreign corporation that holds the U.S. property up through the chain of ownership to the U.S. shareholder.
- If the hypothetical credit is less than the tentative credit, then the amount of foreign taxes deemed paid is limited to the hypothetical credit.

Anti-Sect. 956 Hopscotch (Cont.)



Example

- USP owns CFC1, which owns CFC2. CFC1 has \$200 of E&P and foreign income taxes of \$10. CFC2 has E&P of 100 and foreign income taxes of \$50.
- If CFC2 loans USP \$100, the tentative credit under Sect. 956 would have been \$50 ($\$100/\$100 \times \50), but a hypothetical distribution from CFC2 to CFC1 would increase CFC1's E&P to \$300 and its foreign taxes to \$60.
- A hypothetical distribution from CFC1 to USP would be \$100 (amount of the Sect. 956 inclusion); the deemed paid foreign taxes on that amount would be \$20 ($\$100/\$300 \times \60).
- Even if withholding would otherwise be imposed on a distribution from CFC1 to USP, the withholding taxes are not imposed because it is only a hypothetical distribution. Thus, the credit related to the Sect. 956 inclusion is limited to the hypothetical amount of \$20, representing a blended rate.

Anti-Sect. 956 Hopscotch (Cont.)

	Result Before Anti-956 Hopscotch	Result After Anti-956 Hopscotch
Deemed Dividend Including Gross Up	\$150	\$120
Applicable U.S. Tax Rate	0.35	0.35
U.S. Tax	\$52.50	\$42.00
Foreign Tax Credit	(\$50.00)	(\$20.00)
Net U.S. Tax	\$2.50	\$22.00
Remaining E&P Pool	\$0.00	\$0.00
Remaining Tax Pool	\$0.00	\$30.00

Anti-Sect. 956 Hopscotch: Traps For The Unwary

- Example

- What if, in the prior example, CFC1 had \$100 of previously taxed income (PTI)?
 - The hypothetical cash distribution from CFC1 to USP would be non-taxable as a distribution from PTI. Thus, the hypothetical distribution would result in no foreign taxes.
 - USP is still taxed on the Sect. 956 inclusion, but is not allowed to credit any foreign taxes to offset the 956 inclusion! Double-taxation is the result.
 - Instead, if CFC2 makes an actual distribution to CFC1 and CFC1 makes an actual distribution to USP, then USP is not taxed because the actual distribution is out of PTI.
 - Similar issues arise if CFC1 is running a deficit in its E&P pool.

Anti-Sect. 956 Hopscotch: Traps For The Unwary (Cont.)

- Example (Cont.)
 - Assume further that CFC1 and CFC2 each are guarantors of USP debt. What happens?
 - If the guarantees result in a Sect. 956 inclusion for both CFC1 and CFC2, then USP has multiple Sect. 956 inclusions but may end up with no foreign tax credits.
- In calculating the hypothetical distribution, ignore actual distributions by CFC1 in the same year.
- One-way street: The provision only decreases credits.
- Once this provision defers credits, it may be necessary to have an actual (future) distribution of earnings to clear all of the foreign tax credits out of CFC 2.
 - Future use of those credits could be limited or delayed because of foreign tax credit limitations and the need to pull up all PTI to be able to use the credits.
- **Action item:** Examine holding company structures

Anti-Sect. 956 Hopscotch (Cont.)

- Provision applies to U.S. property acquired by a CFC after Dec. 31, 2010
 - If there is a significant modification of a debt instrument (existing on 12/31/10) such that the original debt instrument is considered as exchanged for a modified instrument, the provision would apply.
- IRS to issue regulations or guidance to carry out purposes of the provision.
- Joint Committee on Taxation description states that the rules apply to deductions of foreign taxes, but it is not clear how the provision could apply to such situations.



Sect. 956 Planning Techniques

After the Education Jobs Act of 2010, several techniques are still available to minimize the impact of Sect. 956

Conduit financing arrangements

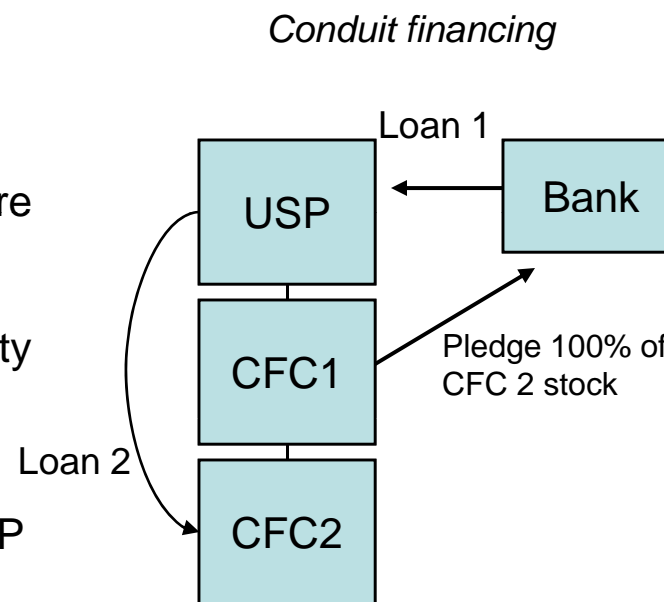
- USP owns CFC1 and CFC2
- CFC1 pledges 100% of the stock of CFC2 to secure loan obtained by USP; USP makes corresponding loan to CFC 2.
- Pledge of CFC 2 stock not considered U.S. property

Splitting lenders/mezzanine financing structure

- USP owns CFC
- USP pledges 65% CFC stock to senior lender, USP pledges 35% CFC stock to junior lender
- Beware syndication of loan

Short-term loans

- 60-180 day rule (Notice 2008-91; through 2010)
- 30-60 day rule (Notice 88-108)





Interest Expense Affiliation Rules

BACKGROUND: To compute the foreign tax credit limitation, a taxpayer must determine its taxable income from foreign sources by allocating and apportioning deductions between its U.S. and foreign source income.

- Sect. 864(e) governs rules for allocating the deduction for interest expense between U.S. and foreign sources

ALLOCATION OF INTEREST EXPENSE TO US GROUP: When allocating interest expense, all members of a domestic affiliated group are treated as a single corporation, and allocation of interest is made based on basis of assets (rather than on income). An affiliated group meant a domestic affiliated group under Sect. 1504, and excluded foreign subsidiaries.

INCLUSION OF FOREIGN SUBS: Under the Treasury regulations, a foreign subsidiary's assets had to be included as part of the U.S. affiliated group for allocating interest expense group if:

- (1) At least 80% of either the vote or value of the corporation's outstanding stock was owned directly or indirectly by members of an affiliated group, and
- (2) More than 80% of the corporation's gross income for the tax year was effectively connected with the conduct of a U.S. trade or business.



Interest Expense Affiliation Rules (Cont.)

The 2010 Education Jobs Act amends the Code definition of affiliated group for interest allocation and apportionment purposes. Thus, for those purposes, a foreign corporation will be treated as a member of an affiliated group if:

- (a) More than 50% of its gross income for the tax year is effectively connected with the conduct of a U.S. trade or business (Code Sect. 864(e)(5)(A)(i) as amended by 2010 Education Jobs Act §216(a)); and
- (b) At least 80% of either the vote or value of all outstanding stock of the corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). (Code Sect. 864(e)(5)(A)(ii))

Effective Date: All tax years beginning after enactment of the Act (i.e., tax years beginning after Aug. 10, 2010)



Repeal Of 80/20 Company Rules

ORIGINAL RULE (sections 861(a) and 871(i)):

Interest or dividend payments from a U.S. corporation to a foreign person are treated as U.S.-source income and subject to a 30% U.S. withholding tax.

If a U.S. corporation satisfies an 80% active foreign business income requirement, then all or a portion of any interest or dividends paid by that corporation (an “80/20 company”) are exempt from U.S. withholding tax.

Interest paid by an 80/20 company is treated as foreign-source income.

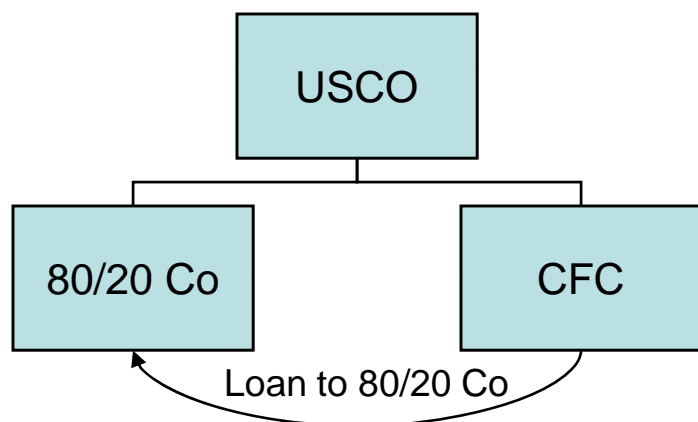
- When an 80/20 company pays interest to a related party, re-sourcing rules apply to the percentage of the interest equal to the percentage of the company’s total gross income from foreign sources during a three-year testing period.

Dividends paid by an 80/20 company remains U.S.-source (for example, for foreign tax credit limitation purposes). However, a percentage of dividends paid by an 80/20 company to a foreign shareholder is exempt from the 30% U.S. withholding tax. The percentage equals the percentage of the 80/20 company’s total gross income during the three-year testing period that is foreign-source.

80/20 Company Abuses

①

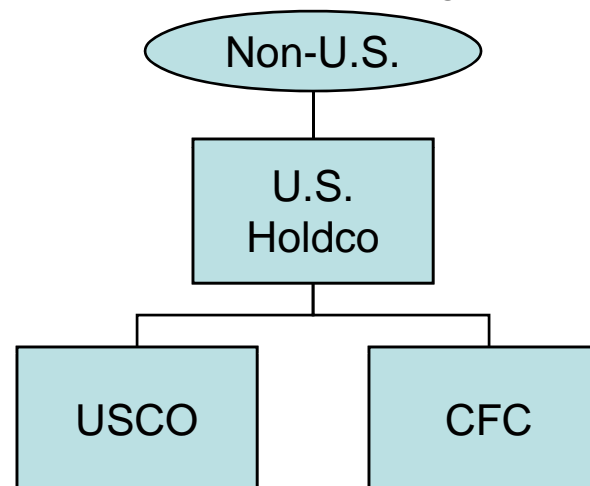
Foreign tax credit
increase



- Interest income (and related foreign tax) incurred by CFC
- If U.S. group has significant assets, the interest expense would be allocated to USCO group
- Lowers U.S. income and increases foreign source income and thus FTC

②

Reduced withholding tax



- Holdco only owns subsidiary stock
- CFC has active business; distributes foreign-source dividends for three years to make U.S. Holdco an 80/20 Co (dividend treated as active income to the extent CFC had active income).
- Dividends from Holdco to non-U.S. shareholders exempt from 30% withholding tax
- In year 4, cash of USCo from US sources is distributed through US Holdco without triggering U.S. withholding tax



Repeal Of 80/20 Company Rules

Original Sect. 871(i) (exemption from withholding), Sect. 861(a)(1)(A) (US source for interest), and Sect. 861(c) (foreign business requirements) repealed

Grandfather rule for 80/20 companies in place as of 12/31/2010

- No 30% withholding tax is imposed under Sect. 871(a) on the active foreign business percentage of:
 - Any dividend paid by an **existing 80/20 company**, and
 - Any interest paid by an **existing 80/20 company**.
- New subsection 871(l) is added to define an existing 80/20 company. In general, the term “existing 80/20 company” means any corporation if:
 - Such corporation met the 80% foreign business requirements of Sect. 861(c)(1) (as in effect before the date of new law) for such corporation’s last taxable year beginning before Jan. 1, 2011.
 - Such corporation meets the 80% foreign business requirements of Sect. 871(l)(1)(B) with respect to each following taxable year.
 - And, there has not been an addition of a substantial line of business with respect to such corporation after the date of the enactment of this subsection.



Repeal Of 80/20 Company Rules (Cont.)

Under grandfather rule, foreign business requirements substantially the same as old rule (three-year testing period, active business income derived from sources outside the U.S., etc.)

However, the grandfather rule only allows 80/20 company exclusion for the “active foreign business percentage” or existing debts

- **Active foreign business percentage (new Sect. 871(l)(1)(B)(2))**
 - The term “active foreign business percentage” means, with respect to any existing 80/20 company, the percentage which:
 - (A) The active foreign business income for the testing period is of
 - (B) The gross income of such company for the testing period from all sources
 - All subsidiaries whose parent owns 50% or greater of the voting stock are included, for purposes of calculating the business income.
- **Existing debt**
 - Debt in place on or before Dec. 31, 2010
 - Does not include related party debt (using Sect. 954(d)(3) rules for related party) or debt with signification modifications

Separate Limitation For Resourced Treaty Income

- Amounts derived from a foreign corporation are generally treated as foreign-source income, for U.S. foreign tax credit limitation purposes.
 - Sect. 904(h) currently provides that interest, dividends and inclusions from controlled foreign corporations and qualified funds are treated as U.S.-source income, to the extent attributable to U.S.-source income of the U.S.-owned foreign corporation (50% or more owned, in vote or value, by U.S. persons).
 - 904(h)(10) special rule: If a U.S. income tax treaty would resource such income as foreign source, and the taxpayer chooses benefits of this special rule, such income is treated as in a separate limitation category, for purposes of the foreign tax credit rules.
 - A similar separate basket rule applies under Sect. 865(h) to resourced gains from the sale of certain foreign corporation stock or intangibles.
- The U.S. model treaty provides that an item of gross income that may be taxed in the treaty country is deemed to be foreign-source income.
- Prior to the change in law, income-producing assets could be transferred to foreign branches and disregarded entities.
 - Income from the assets could be resourced pursuant to a tax treaty, resulting in increased foreign source income and a higher foreign tax credit limitation in the relevant limitation basket.

Separate Limitation For Resourced Treaty Income (Cont.)

The Education and Jobs Act adds paragraph 904(d)(6), requiring a separate basket for items resourced to foreign source under treaties.

- Applies to income earned by branches and disregarded foreign subsidiaries
 - Does not apply to items of income covered by 904(h)(10) or 865(h)
- Prevents the cross-crediting of income that has been resourced under a treaty (or the related foreign taxes).
- Effective for taxable years beginning after Aug. 10, 2010.
- Regulations may be issued, including guidance providing:
 - That related items of income may be aggregated, or that
 - Items from the same trade or business may be grouped.

Modification Of Statute Of Limitations For Failure To Disclose Foreign Transactions

- Sect. 6501(a)(1) provides the general rule that a tax must be assessed within three years after the taxpayer's return was filed.
- Prior to enactment (on March 18, 2010) of the Hiring Incentives to Restore Employment Act (HIRE Act, P.L. No. 111-147), Sect. 6501(c)(8) provided an exception that the time for assessment will not expire earlier than three years after certain required information (relating to foreign or foreign-owned entities) is reported to the IRS, with respect to any event or period to which such information relates.
- Sect. 513(c) of the HIRE Act modified Sect. 6501(c)(8), by keeping open the statute of limitations for the entire return until three years after the required information returns are filed.
 - Effective for returns filed after March 18, 2010, and returns filed before March 18, 2010 if the time for assessment of such taxes had not expired before that date.
- After significant outcry from taxpayers, the Education and Jobs Act further modifies Sect. 6501(c)(8) by adding an exception due to reasonable cause (and not willful neglect) for failure to furnish the required information.
 - If the taxpayer establishes reasonable cause, the limitations period is suspended only for the item or items related to the failure to disclose.
 - Effective date relates back as if originally included in HIRE Act

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS in Circular 230, we inform you that any information contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or other matter addressed herein.