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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
Allen Littman, Partner, **Baker Hostetler**, Washington, D.C.
LaVonda Napka, **Thompson Hine**, Cleveland
Stephen Feldman, Partner, **Morrison & Foerster**, New York
William Winter, Tax Partner, **Morris, Manning & Martin**, Atlanta

Thursday, October 7, 2010

The conference begins at:
1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

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THOMPSON HINE

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INTERNATIONAL TAX UPDATE

International Tax Provisions of Education Jobs and Medicaid Assistance Act

On August 10, President Obama signed into law the Education Jobs and Medicaid Assistance Act of 2010, P.L. 111-226 (the "Act"). Among the revenue-raising provisions included in the Act were several international tax provisions, which are described below.

DENIAL OF FOREIGN TAX CREDIT FOR COVERED ASSET ACQUISITIONS

A common foreign tax credit planning technique employed by U.S. corporate acquirors has been to make a Section 338(g) election for stock acquisitions of foreign target corporations. The Act adds new Section 901(m), which severely limits the potential tax benefit of such Section 338(g) elections by denying a foreign tax credit for the "disqualified portion" of foreign income taxes paid or accrued in connection with a "covered asset acquisition." In addition to qualified stock purchases for which a Section 338 election is made, "covered asset acquisitions" include:

- Acquisitions of an interest in a partnership that has a Section 754 election in place;
- Any transaction that is treated as an asset acquisition for purposes of U.S. income tax and a stock acquisition (or a disregarded transaction) for purposes of the foreign income taxes of the relevant foreign jurisdiction (for example, a stock acquisition of a foreign entity that is treated as a disregarded entity for U.S. tax purposes, but as a corporation for foreign tax purposes); and
- Any other similar transaction to the extent provided by the IRS.

A covered asset acquisition often results in a higher tax basis for the target business's assets for U.S. tax purposes than for foreign tax purposes. In those cases, for the years subsequent to the covered asset acquisition, the target business will have larger deductions (and smaller taxable income) for U.S. tax purposes than for foreign tax purposes. Essentially, a permanent difference will result between the foreign taxable income upon which foreign income tax is imposed and the U.S. taxable income upon which U.S. income tax is imposed. The "disqualified portion" of the foreign income taxes paid or accrued for a subsequent taxable year is based on a formula designed to capture the amount of foreign income taxes payable on the portion of such permanent difference attributable to such subsequent taxable year. Although the Act denies a foreign tax credit for the disqualified portion, in certain circumstances, the disqualified portion may be deductible for U.S. tax purposes.

New Section 901(m) applies to covered asset acquisitions occurring on or after January 1, 2011. A favorable transitional rule may apply for covered asset acquisitions between unrelated parties occuring on or after January 1, 2011 for which a binding written contract is in place as of that date and at all times thereafter.

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PREVENTING SPLITTING FOREIGN TAX CREDITS FROM RELATED FOREIGN INCOME

Tax planning techniques have been developed by which foreign income taxes are split off from the related foreign income on which such foreign income taxes were paid or accrued. By these techniques, the split-off foreign income taxes are available for U.S. foreign tax credit purposes even though the related foreign income is not subject to U.S. income tax.

The Act adds new Section 909, which establishes a matching rule to prevent the separation of creditable foreign taxes from the related foreign income. Generally, 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. Additionally, if there is a "foreign tax credit splitting event" with respect to foreign income tax paid or accrued by a foreign corporation for which a U.S. corporate shareholder is eligible to take a Section 902 deemed paid foreign tax 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.

"A foreign tax credit splitting event" with respect to a foreign income tax is one where the related foreign income is (or will be) taken into account for U.S. tax purposes by a "covered person." A covered person generally is one who is related in any of the following ways to the person who paid or accrued the split-off foreign income tax (the "payor"):

- Any entity in which the payor holds, directly or indirectly, at least a 10 percent ownership interest (determined by vote or value);
- Any person who holds, directly or indirectly, at least a 10 percent ownership 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.

Generally, new Section 909 also applies to partnerships, S corporations and trusts. In the case of a foreign tax credit splitting event involving any such entities, the matching rule is to be applied at the partner, shareholder or beneficiary level, as the case may be.

Generally, new Section 909 is effective for foreign income taxes paid or accrued in taxable years beginning after December 31, 2010. However, for foreign income taxes paid or accrued by a foreign corporation for which a U.S. corporation is eligible to take a Section 902 deemed paid foreign tax credit, new Section 909 is effective for taxable years beginning on or before December 31, 2010, but only for purposes of applying Sections 902 and 960 with respect to periods after such date.

LIMITATION ON AMOUNT OF FOREIGN TAXES DEEMED PAID WITH RESPECT TO SECTION 956 INCLUSIONS

Where a lower-tier controlled foreign corporation (CFC) makes an acquisition of U.S. property resulting in a Subpart F income inclusion under Sections 951(a)(1)(B) and 956, for purposes of the Section 902 deemed paid foreign tax credit, such CFC is essentially treated as paying a deemed dividend directly to the U.S. parent corporation. Consequently, the foreign income taxes deemed paid for purposes of the Section 902 foreign tax credit are those foreign income taxes paid by such lower-tier CFC. The deemed dividend essentially "hopscotches" over the higher-tier foreign corporate subsidiaries for purposes of the Section 902 foreign tax credit.

For an acquisition of U.S. property made after December 31, 2010, new Section 960(c) generally requires that the amount of foreign income taxes, deemed to have been paid under Section 902 attributable to a Subpart F income inclusion under Sections 951(a)(1)(B) and 956, shall not exceed the amount of the foreign income taxes that would have been deemed to have been paid during the taxable year if cash in an amount equal to such income inclusion were distributed as a series of distributions up through the chain of foreign corporations, if any, to the U.S. parent corporation. Where upper-tier foreign corporations are organized in low-tax jurisdictions or tax havens, new Section 960(c) may result in a lower Section 902 deemed paid foreign tax credit.

LIMITATION ON SECTION 304 TRANSACTIONS

Under current law, certain Section 304 transactions can result in the tax-free distribution of earnings and profits (E&P) from an acquiring CFC to a transferor foreign corporation that is not a CFC. These distributed E&P may permanently escape U.S. taxation. The Act amends Section 304(b)(5)(B) by providing that in the case of a Section 304 transaction with a foreign acquiring corporation, no E&P shall be deemed to have been distributed by the acquiring foreign corporation if more than 50 percent of the dividends arising from such acquisition (determined without regard to amended Section 304(b)(5)(B)) would neither be subject to U.S. income tax for the taxable year in which the dividends arise nor be includible in the E&P of a CFC. Amended Section 304(b)(5)(B) is effective for acquisitions made after August 10, 2010.

TERMINATION OF SPECIAL RULES FOR 80/20 COMPANIES

Under current law, a U.S. corporation that pays interest or dividends to foreign persons is exempt, at least in part, from U.S. withholding tax if at least 80 percent of such corporation's gross income during the three-year testing period is derived from foreign sources and is attributable to the active conduct of a trade or business in a foreign country (or a U.S. possession) by such corporation (or by a 50 percent owned subsidiary of such corporation). Although the Act repeals this exemption from U.S. withholding tax for taxable years beginning after December 31, 2010, it provides a grandfather rule that may continue to exempt from U.S. withholding tax a corporation that currently meets the 80 percent gross income test. Also, a second grandfather rule provides that the

repeal does not apply to interest payments made to unrelated persons on debt obligations issued before August 10, 2010.

Modification of Affiliation Rules for Purposes of Rules Allocating Interest Expense

The Act amends Section 864(e)(5)(A) to increase the likelihood that more interest expense will be allocated or apportioned to the U.S. affiliated group for purposes of computing the foreign tax credit limitation. Under amended Section 864(e)(5)(A), a foreign corporation will be treated as a member of the U.S. affiliated group if more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected with the conduct of a U.S. trade or business; and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the U.S. affiliated group. Amended Section 864(e)(5)(A) is effective for taxable years beginning after August 10, 2010.

Separate Application of Foreign Tax Credit Limitation to Items Resourced Under Tax Treaties

New Section 904(d)(6) applies a separate foreign tax credit limitation for any item of income that meets the following three requirements:

- The item of income is treated as derived from U.S. sources under U.S. tax law (determined without regard to a tax treaty obligation);
- The item of income is treated as arising from sources outside the U.S. under a tax treaty obligation of the U.S.; and
- The item of income is one for which the taxpayer chooses the benefits under such tax treaty obligation.

New Section 904(d)(6) does not apply to items of income to which the coordination rules of Sections 904(h)(10) and 865(h) apply. New Section 904(d)(6) applies to taxable years beginning after August 10, 2010.

Limited Relief Regarding Extension of Statute of Limitations for Failure to Notify IRS of Certain Foreign Transfers

Prior to the enactment of Section 513 of the Hiring Incentives to Restore Employment Act (the "HIRE Act"), Section 6501(c)(8) provided what tax practitioners believed to be a limited exception to the three-year statute of limitations for assessments. In a case where a taxpayer filed its tax return but failed to provide the information required to be reported under Section 6038, 6038A, 6038B, 6046, 6046A or 6048 with such return (for example, the taxpayer failed to file a Form 5471, Form 8865, Form 5472, Form 926 or Form 3520), tax practitioners understood that the

statute of limitations began to run for the tax year, except for items related to such failure. For those few items related to such failure, the statute of limitations did not begin to run until the information required to be reported was filed with IRS.

Under Section 513 of the HIRE Act, Congress amended the language of Section 6501(c)(8) to clarify that a failure by a taxpayer to provide the information required to be reported pursuant to an election under Section 1295(b) or under Section 1298, 6038, 6038A, 6038B, 6038D, 6046, 6046A or 6048 causes all items on the tax return to remain open; that is, the statute of limitations does not begin to run for any items on the return.

In the Act, Congress provided limited relief to taxpayers by amending Section 6501(c)(8) to provide that if a failure to furnish the required information is due to reasonable cause and not willful neglect, the statute of limitations would begin to run for all items reported on the return except for the items related to such failure. The Joint Committee on Taxation anticipates that to prove reasonable cause a taxpayer must establish that the failure was objectively reasonable (that is, the taxpayer had put in place adequate measures to ensure compliance with applicable rules and regulations) and in good faith. Amended Section 6501(c)(8) is effective as if included in Section 513 of the HIRE Act.

FOR MORE INFORMATION

Please contact one of the lawyers listed below for more information regarding the international tax provisions of the Act.

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