NEW TAX ACT PROVISIONS

On August 10, the Education Jobs and Medicaid Assistance Act was signed into law. The new law contains several new provisions relating to the foreign tax credit.

First, new Code §909 is added to the Internal Revenue Code. Without getting bogged down in the details, the new provision delays the foreign tax credit or deduction for a taxpayer until the foreign income that gives rise to the foreign tax is taken into account by the taxpayer – if this never happens, then the credit or deduction is lost for good. The delay is triggered by a "splitting" transaction which is when the related income is taken into account by related entities or persons to the taxpayer who seeks the credit or deduction. Congress was concerned that some taxpayers were engaging in tax structuring so that foreign income was incurred by related persons or entities that are not currently subject to U.S. tax while still allowing the income to generate U.S. foreign tax credits that can be used to offset U.S. tax on other foreign income. The deferment of the credit or deduction will also apply for deemed paid credits under Code §§902 and 960.

Another new provision is Code §901(m), which acts to disallow a portion of the foreign tax credit or deduction for actual or deemed asset acquisitions that arise in certain circumstances (referred to as "covered asset acquisitions"). The genesis of this provision is a concern that U.S. taxpayers were obtaining basis step-ups in foreign assets in transactions that did not result in a basis step-up for foreign purposes. Thus, such assets could generate more income or gain or less depreciation in foreign jurisdictions than is arising in the U.S., giving rise to more foreign tax and less U.S. tax. The new provision, again in a complex manner, targets this extra foreign income tax and denies foreign tax credits and deductions for it. Covered asset acquisitions include (a) Section 338 qualified stock purchases that are treated as asset acquisitions, (b) other transactions which are treated as asset acquisitions fore U.S. tax purposes but are treated as stock acquisitions or are disregarded for purposes of the foreign income taxes of the relevant foreign jurisdiction (e.g., the purchase of shares of a corporation that is disregarded for U.S. tax purposes), and (c) acquisitions of partnership interests for which a Code §754 election is in place. Again, the common denominator in these acquisitions is a basis step-up in assets for U.S. purposes, but not foreign tax purposes.

Lastly, new language under Code §904(d)(6) seeks to restrict the availability of foreign tax credits and deductions for taxpayers that have income which would be treated as U.S. source but which is instead characterized as foreign source under a treaty. The concern is that this increase in foreign source income under a treaty, which is often of a type that is lightly taxed by the foreign jurisdiction, creates more foreign source income than is appropriate (which foreign source income allows for greater taxpayer credits and deductions). The new provision effectively creates separate baskets for each such item of income, thus allowing only the foreign taxes imposed on each such item to be creditable or deducted. Thus, each item of income must be separately tracked and analyzed.

COMMENTS: The foreign tax credit is already a complex area, that is little understood beyond those that often deal with it. The foregoing provisions address legitimate concerns of the government. However, the remedies further complicate the area, and will result in additional taxpayer compliance costs and frustration. Taxpayers would like to understand the laws applicable to them, and would also not like to have to pay substantial fees to advisors and accountants to have them explained and applied. The complexity of these new provisions indicates the total disregard for these taxpayer concerns by Congress.

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