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LEGAL ALERT

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New International Tax Provisions Take Aim at Foreign Tax Credit Planning But Also Provide Some Relief Under Section 6501(c)(8)

On August 10, 2010, President Obama signed into law the Education Jobs and Medicaid Assistance Act, P.L. 111-226, which provides funds to the states for teachers' salaries and Medicaid costs. To fund this bill, Congress enacted all but one of the international revenue offsets contained in the Extenders Bill, which of course raises questions about funding for the Extenders Bill. The sole international offset from the Extenders Bill not included in this legislation was the provision to source guarantee fees in the same manner as interest rather than as services compensation. It is important to note that the effective dates have been changed to be prospective, generally after December 31, 2010, rather than as of May 20, 2010, which was the effective date in the Extenders Bill.

The revenue provisions in this legislation primarily eliminate certain foreign tax credit planning strategies, but also curtail 80-20 companies with limited grandfather provisions. Also, foreign companies did not escape the reach of the legislation. Section 304 was amended to prevent foreign companies from using section 304 to remove earnings and profits from the United States, which previously could permit tax-free repatriation of U.S. profits. Finally, a taxpayer-friendly amendment to section 6501(c)(8) limits the extent to which a tax year will remain open when a taxpayer has reasonable cause for not filing a required information return.

The amendment to section 6501(c)(8) provides a technical change to the prior version of the amendment, which makes clear that if a taxpayer has reasonable cause for not filing an information return, only the items relating to that information return will remain open and not the whole return. This is a welcome change from a financial reporting perspective. However, it remains to be seen how the reasonable cause standard will be applied in this context.

Foreign Tax Credit Amendments

The foreign tax credit amendments are extensive. Each of the provisions is aimed at the same purpose, which is to reduce the opportunities to create excess foreign tax credits that may be used to offset U.S. taxes on low-taxed foreign income. While some of the provisions have been anticipated for a number of years, such as the "anti-splitter" provision, others, such as the limitation on foreign taxes paid as a result of foreign base differences, were newly introduced this year.

"Covered Asset Acquisitions." Planning for acquisitions of a foreign group under section 338 was a standard strategy to make an acquisition more affordable for the U.S. acquiror. In addition to a section 338 election, other strategies, including section 754 and check-the-box elections that have the same effect of creating permanent base differences, will not be able to generate excess foreign taxes that may be credited against U.S. tax on other foreign income. Together, such transactions are referred to as "covered asset acquisitions." Foreign taxes paid on the portion of the higher foreign taxable base will be disqualified as foreign tax credits on the basis of a ratio. A deduction, however, will still be permitted for such disqualified foreign taxes.

"Anti-Splitter" Provision. The "anti-splitter" provision codifies prior IRS proposed regulations that would reverse the decision in *Guardian Industries v. U.S.,* 477 F.3d 1368 (Fed. Cir. 2007), and essentially apply a matching rule for foreign taxes and income. Under the new section 909 matching rule, income would have to be recognized in the United States in order for the foreign taxes imposed on the income to be eligible for a U.S. foreign tax credit. The provision is aimed at planning involving hybrid instruments and hybrid entities. The Joint Committee Technical Explanation, JCX-46-10, (JCTE) does suggest some limits on what should be treated as a "foreign tax credit splitting event," noting that differences in timing when income is taken into account for U.S. and foreign law purposes should not be treated as a "splitter event."

Elimination of "Hop-scotch" in Section 956. Another surprising provision eliminates the "hop-scotch" provision of section 956 inclusions. Surprising, because the "hop-scotch" provision remains a feature of subpart F inclusions. Under current law, when a controlled foreign corporation (CFC) makes a loan to a U.S. shareholder, the loan is treated as a distribution directly from the CFC to its U.S. shareholder, thereby "jumping" over any intervening CFCs. That "hop-scotch" prevents any dilution of high tax foreign tax credits with low tax credit pools in any intervening CFCs. The new provision will require a hypothetical distribution of the inclusion through any intervening CFCs, which will limit the foreign tax credit attributable to the section 956 inclusion to the amount of foreign tax credits that would have been available if the inclusion had been actually distributed up through the chain of intervening CFCs. Needless to say, the calculations involved in this limitation will be complex and recordkeeping will be paramount.

The amendment applies to acquisitions of U.S. property by a CFC after December 31, 2010. The JCTE explains that any section 956 inclusions (even if triggered after December 31, 2010) from a CFC loan made to its U.S. parent before January 1, 2011, will not be subject to the no "hop-scotch" rule. However, in such a case, the "hop-scotch" rule will apply if there is a significant modification to the CFC loan resulting in a deemed exchange for a modified loan that differs materially from the original loan. Although this effective date creates planning opportunities for U.S. investments made prior to January 1, 2011, those opportunities may be tempered by the potential application of the existing anti-abuse rule under Treas. Reg. §1.956-1T(b)(4).

80-20 Provision Repealed With Grandfather Provision For Existing 80-20 Companies

The 80-20 provision for U.S. companies that earn at least 80% of their income from foreign sources has been repealed, except in the case of existing 80-20 companies that qualify for continued treatment under the grandfather provision. Under the grandfather provision, the testing period for income qualification is the three-year period that ends with the close of the taxable year of the corporation preceding the payment of interest or dividends. However, unlike current law, for purposes of the test, an existing 80-20 corporation must take into account on an aggregate basis the income of its 50% or more owned domestic and foreign subsidiaries. If an existing 80-20 company adds a substantial line of business after August 10, 2010, it will not meet the grandfather rule. Moreover, according to the JCTE, the acquisition of foreign operating assets or stock of a foreign corporation for the purposes of meeting the 80% active foreign income test will be treated as the addition of a substantial line of business.

Section 304 Repatriation Planning Strategy for Foreign Multinationals Eliminated

Foreign parent companies of multinational groups were not overlooked by this legislation. The use of section 304 by foreign multinationals to repatriate earnings of their U.S. groups without U.S. taxation on that repatriation through a cross-group sale of a subsidiary will no longer be available. Similar to the section 956 "hop-scotch," under current law, earnings bypassed any intermediary shareholders. The result was a foreign-to-foreign dividend that was not subject to U.S. withholding tax under section 1442. Section 304 has been amended to prevent the movement of earnings and profits from U.S. companies to foreign companies so as to escape U.S. taxation. This amendment essentially retains the earnings and profits in the acquiring and acquired company when those earnings and profits otherwise would have been treated as being distributed directly to a foreign company under section 304(a).

Other Provisions

Two other provisions were enacted as well. A new "basket" was added to section 904(d) for domestic source income that is resourced under an income tax treaty. The new separate limitation will prevent foreign taxes imposed on such income from offsetting other foreign source income.

Finally, a clarification was made to the interest allocation provisions. Under that provision, when a foreign corporation is treated as a member of an affiliated group for interest allocation purposes, all of the foreign corporation's worldwide assets and interest expense will be taken into account for allocating that foreign corporation's interest expense.

Summary

The provisions described above, particularly the foreign tax credit provisions, change the U.S. tax planning landscape dramatically, especially for acquisition planning. If that were not enough, the Obama Administration's proposed single foreign tax credit pool still hangs in suspense. It may be an interesting fall and winter.

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If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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