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Legal Update
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Significant Revisions to US International Tax Rules

The Education Jobs and Medicaid Assistance Act of 2010 (Pub. L. No. 111-226) (the "Act") became law on August 10, 2010. While the Act's primary purpose is to provide financial assistance to US states for education and Medicaid spending, several international tax provisions were included to offset the spending increases. These international offsets are estimated to raise approximately $10 billion over 10 years. Unlike the similar international offset provisions considered by the House and the Senate in May and June as part of a bill extending various tax provisions, the international offsets included in the Act generally apply prospectively.

Observation. As a result of the so-called "pay-go" rule, Congress will need to find a new source of revenue to offset the extension of various tax provisions, including the section 954(c)(6) look-thru rule under subpart F.[1]

Section 909—Prevention of Foreign Tax Credit Splitting

New section 909 adopts "matching rules" that are intended to prevent the separation of creditable foreign taxes from the associated foreign income. Under the general rule, if a "foreign tax credit splitting event" occurs with respect to a foreign income tax paid or accrued by the taxpayer, such foreign income tax is not taken into account for US tax purposes until the tax year in which the related income is taken into account by the taxpayer for US tax purposes. Availability of such foreign income tax as a foreign tax credit is then subject to the generally applicable foreign tax credit limitation rules. A "foreign tax credit splitting event" occurs with respect to a foreign income tax if the related income is (or will be) taken into account by certain persons that are directly or indirectly related to the taxpayer under one of the tests in new section 909(d)(4).

Section 909 also provides that if a foreign tax credit splitting event occurs with respect to a foreign income tax paid or accrued by a section 902 corporation (i.e., any foreign corporation in which a domestic corporation owns at least 10 percent of the voting stock), then the foreign income tax is not taken into account immediately for purposes of (i) the deemed paid credits under section 902 or section 960 or (ii) determining earnings and profits (E&P) under section 964(a). Instead, the foreign income tax is taken into account in the tax year in which the related income is taken into account by the section 902 corporation, or certain related domestic corporations. Therefore, such foreign income tax is not added to the section 902 corporation's foreign tax pool, and its E&P is not reduced by such tax, until the related foreign income is taken into account.

Observation. Section 909 addresses structures similar to those involved in Guardian Industries (*Guardian Indus. Corp. and Subsidiaries v. United States*, 477 F.3d 1368 (Fed. Cir. 2007)). In *Guardian Industries* foreign income taxes payable by the disregarded parent of a foreign consolidated group were held to be available to the US owner of the foreign parent notwithstanding the fact that the income of the

subsidiary members of the group, corporations for US tax purposes, did not "flow through" to the US owner. However, the new provision is potentially applicable to a much wider range of structures and transactions.

In addition, the "matching rules" of section 909 do not follow the "anti-splitting" rules previously proposed by the IRS in proposed regulations. For example, in a situation where a US corporation owns an interest in a foreign partnership that is treated as a corporation for US tax purposes (a "reverse hybrid"), the previously proposed regulations would have treated foreign taxes imposed on the US corporation with respect to the income of the reverse hybrid as tax imposed on the reverse hybrid (i.e., the taxes would be "pushed down" into the reverse hybrid, with associated corollary consequences). In contrast, in the same scenario, section 909 would continue to treat the foreign taxes as imposed on the US corporation, but would suspend such taxes until inclusion of the related income by the US corporation.

Section 909 is effective for foreign income taxes paid or accrued in taxable years beginning after December 31, 2010. Section 909 is also effective for foreign income taxes paid or accrued by a section 902 corporation in taxable years beginning on or before December 31, 2010 (and not deemed paid under section 902(a) or section 960 on or before such date), but only for purposes of applying sections 902 and 960 with respect to periods after such date (the "deemed-paid transition rule"). However, no adjustment is made to a section 902 corporation's E&P for the amount of any foreign income taxes suspended under the deemed-paid transition rule, either at the time of suspension or when such taxes are subsequently taken into account under the provision.

Observation. The deemed-paid transition rule means that foreign taxes paid or accrued by a section 902 corporation for pre-2011 tax years generally are subject to section 909's matching rules if such taxes are not deemed paid under section 902(a) or section 960 on or before December 31, 2010. Taxpayers may thus be subject to suspension of foreign tax credits with respect to pre-2011 foreign taxes.

Section 901(m)—Disallowance of Foreign Tax Credits following Covered Asset Acquisitions

Newly enacted section 901(m) limits the foreign tax credits available after a "covered asset acquisition." The term "covered asset acquisition" is defined to include (i) a qualified stock purchase to which section 338(a) applies, (ii) an acquisition of an interest in a partnership that has made a section 754 election to adjust the inside basis of partnership assets, (iii) any transaction that is treated as an acquisition of assets for US federal income tax purposes but as an acquisition of stock of a corporation for foreign income tax purposes and (iv) other similar transactions identified by the Treasury. The third category of transaction includes acquisition of hybrid entities, such as entities that "checked the box" to be disregarded for US federal income tax purposes but remain corporations for foreign income tax purposes.

The portion of foreign income taxes paid or accrued in a particular tax year that are disqualified, and thus non-creditable is equal to the ratio (expressed as a percentage) of (i) the "aggregate basis differences" (but not below zero) allocable to such taxable year with respect to all relevant foreign assets, divided by (ii) the income on which the foreign income tax is determined. According to the Joint Committee on Taxation's Technical Explanation of the final Senate Amendment that became the Act, the relevant income in making this calculation is determined pursuant to the law of the relevant foreign jurisdiction. The aggregate basis difference, with respect to any relevant asset, is the excess of (i) the adjusted basis immediately after the acquisition over (ii) the adjusted basis immediately before the acquisition.

For example, assume a US corporation acquires for $150 the stock of a foreign target that has one asset with an adjusted basis of $0. Further assume

that the US corporation makes a section 338(g) election with respect to the acquisition that results in a $150 basis step-up that would generate $10 a year in additional depreciation/amortization. The aggregate basis difference would be $150, of which $10 would be allocable to each of the next fifteen taxable years. If in the taxable year after the acquisition the target had foreign income of $40 that was subject to $12 in foreign income tax, then the non-creditable portion would be equal to the ratio of $10 divided by $40 (i.e., 25 percent). Thus, $3 (25 percent of $12) in foreign income taxes would be non-creditable for the taxable year.

Observation. The adjusted basis number used in calculating the aggregate basis difference is the US federal income tax basis of such foreign assets. This may place a significant compliance burden on US taxpayers making a "covered asset acquisition" because the US federal income tax basis of the relevant foreign assets may not have previously been relevant.

Section 901(m) applies to covered asset acquisitions occurring after December 31, 2010, unless transition relief is available for the acquisition. Transition relief is available with respect to an acquisition from an unrelated transferor if such acquisition is (i) made pursuant to a written agreement that was binding on January 1, 2011, and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before July 29, 2010, or (iii) described on or before January 1, 2011, in a public announcement or in a filing with the Securities and Exchange Commission.

Observation. A basis step-up resulting from a section 331 liquidation of a controlled foreign corporation accomplished via a check the box election effective prior to December 31, 2010, may not be subject to the limitation in section 901(m).

Section 960(c)—Limitation on Deemed-Paid Taxes for Section 956 Inclusions

In general, the US shareholders of a controlled foreign corporation (a "CFC") are required to include a pro rata share of any increase in the earnings of the CFC that are invested in US property (a "section 956 inclusion"). When a lower-tier CFC invests in US property, it is treated as though the lower-tier CFC paid a dividend directly to the US shareholder pursuant to the so-called "hopscotch rule" for the purposes of calculating the foreign taxes that the US shareholder is deemed to pay. Taxpayers have affirmatively used the hopscotch rule to prevent the dilution of the effective rate of foreign taxes paid by a high-taxed, lower-tier CFC where an actual payment of a dividend up the ownership chain would pass through a low-taxed, upper-tier CFC. New section 960(c) limits the amount of foreign taxes the US shareholder is deemed to pay to the amount of taxes the US shareholder would have been deemed to have paid if a dividend had actually been paid up the ownership chain from the lower-tier CFC to the US shareholder. Section 960(c)(2) requires Treasury to issue regulations or other guidance to carry out the purposes of section 960(c) and to "prevent the inappropriate use of the foreign corporation's foreign income taxes not deemed paid by reason" of section 960(c).

Observation. The limitation on deemed-paid taxes in section 960(c) is intended only to operate when the US shareholder is disadvantaged by the result.

The provision applies to income inclusions attributable to US property acquired by a CFC after December 31, 2010.

Section 304(b)(5)(B)—Limit on Deemed Dividends in Redemptions by Foreign Subsidiaries

New section 304(b)(5)(B) eliminates the application of a favorable deemed payment rule for certain transactions involving a foreign corporation owned, in whole or in part, by a US taxpayer (which would include a CFC) that repatriates its E&P to a foreign person outside US taxing jurisdiction. Depending on the particular facts of a transaction, the elimination of such

deemed payment rule can have the effect of subjecting the transaction to US withholding tax.

The perceived abuse is illustrated by facts where a non-CFC foreign member of a group (the "Seller") sells stock of a US member of the group (the "Target Corporation") to a brother/sister corporation that is a CFC (the "Acquiring Corporation") for "Property" (e.g., cash). Section 304 recharacterizes such a transaction as the Seller contributing the Target Corporation stock to the Acquiring Corporation in a section 351 tax-free exchange for deemed Acquiring Corporation stock. That deemed Acquiring Corporation stock is then deemed to be redeemed under section 302 from the Seller in exchange for the property. Because of the direct and indirect continuing ownership that the Seller has in the Acquiring Corporation, that redemption will generally be treated as a dividend under section 301.

Under prior law, the amount and payor of the resulting dividend was determined as if the Property was distributed first by the Acquiring Corporation to the extent of its E&P (subject to certain limitations where the acquiring corporation is foreign) and then by the Target Corporation to the extent of its E&P. To the extent the dividend distribution is deemed paid by the Acquiring Corporation, the Seller is considered to have received a dividend directly from the Acquiring Corporation, bypassing any intermediary shareholders such as the US group. Thus, under prior law, it was possible, in certain circumstances, for a CFC to purchase stock of a related corporation for cash or other property and have that cash or property be treated as a dividend paid directly from that CFC to the foreign parent of the US group. Unlike a dividend paid up the corporate chain, such a direct dividend would not be subject to either US corporate income tax in the US group or US withholding tax.

Observation. In the example above, Target Corporation is a US corporation, the stock of which is US property for the purposes of section 956. Thus, a purchase of the stock of Target Corporation may result in a section 956 inclusion to the extent any E&P remains in Acquiring Corporation (a CFC) after the application of section 304.

New section 304(b)(5)(B), where applicable, provides that the E&P of a foreign acquiring corporation will not be utilized to determine the amount and source of a dividend resulting from a transaction governed by section 304. As a result, the distribution would instead generally be treated as a dividend paid only from the target corporation to the extent of the target corporation's E&P. Section 304(b)(5)(B) thereby effectively prevents the foreign acquiring corporation's E&P from permanently escaping US taxation without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation. If the target corporation is a US corporation and section 304(b)(5)(B) results in a deemed dividend being received from the target corporation, such dividend generally will be subject to 30 percent US withholding tax unless reduced by a tax treaty.

New section 304(b)(5)(B) applies if more than 50 percent of the dividends arising from the acquisition (before taking into account the provision) would not be (i) subject to US tax in the year in which the dividend arises or (ii) includible in the E&P of a CFC. According to the Joint Committee on Taxation's Technical Explanation of the final Senate Amendment that became the Act, it is anticipated that regulations will provide a rule 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 provision applies to acquisitions occurring after the date of enactment of the Act.

Observation. Taxpayers should be cognizant of section 304(b)(5)(B) when effectuating group restructurings, particularly where cash or property is paid by a CFC in exchange for stock of a US corporation. As discussed above, if section 304(b)(5)(B) applies to the restructuring, the

result may be a deemed dividend from the US target corporation that could be subject to US withholding tax.

Section 864(e)(5)(A)—Modification of Affiliation Rules for Interest Expense

The Act amends the definition of the term "affiliated group" in section 864(e)(5) for the purposes of allocating and apportioning interest expense. Under this provision, all of a foreign corporation's assets and interest expenses will be taken into account by the US affiliated group if such foreign corporation is at least 80 percent owned (directly or indirectly, by vote or value) by members of the affiliated group and if more than 50 percent of the foreign corporation's gross income for the taxable year is effectively connected with the conduct of a US trade or business (an "80/50 corporation").

Observation. Section 864(e)(5)(A) effectively codifies and expands on the rule contained in Treas. Reg. § 1.861-11T(d)(6)(ii), which provides that assets and interest expenses of an 80/50 corporation that generate effectively connected income are taken into account by the US affiliated group for the purpose of allocating and apportioning interest expenses. By expanding the assets and interest expenses of an 80/50 corporation that are taken into account from just those that generate effectively connected income to all assets and interest expenses, this provision is potentially more burdensome to taxpayers than the prior rule in Treas. Reg. § 1.861-11T(d)(6)(ii).

This provision is effective for tax years beginning after August 10, 2010.

Section 861(a)(1)—Repeal of 80/20 Rules

The Act repeals the rules that generally exempted from US withholding tax any interest and a portion of dividends paid by a corporation if at least 80 percent of the corporation's gross income during a three-year period ending on the close of the tax year preceding the payment is foreign source income and is attributable to the active conduct of a foreign trade or business (the "80/20 rules").

Subject to an exception for certain existing 80/20 companies and a grandfather provision generally applicable to payments of interest on obligations issued before August 10, 2010, the Act repeals the 80/20 rules for taxable years beginning after December 31, 2010.

Section 904(d)(6)—Separate FTC Basket for Items Resourced under Treaties

New section 904(d)(6) segregates income generated by a foreign branch of a US corporation into a separate foreign tax credit limitation if such income is (i) US source under internal US tax law, (ii) resourced as foreign under a tax treaty, and (iii) the taxpayer chooses the benefits of the treaty. Pursuant to section 904(h), such a separate foreign tax credit limitation already applies to amounts derived from a US-owned foreign corporation that are resourced under a tax treaty. The aim of section 904(d)(6) is to prevent excess foreign tax credits of a US corporation from effectively being netted against the notional excess foreign tax credit limitation generated by the corporation's additional resourced branch foreign source income.

This provision is effective for tax years beginning after August 10, 2010.

Section 6501(c)(8)(B)—Technical Correction to the Expanded Statute of Limitations Period

On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (Pub. L. No. 111-147) (the "HIRE Act"), which provided, in part, that the extended period to assess taxes upon the failure to report certain foreign transactions in section 6501(c)(8) applies to the taxpayer's entire tax return rather than just the items related to the specific unreported transaction. See our April 20, 2010 Legal Update, "Foreign Account Tax Compliance Act of 2009"

available at http://www.mayerbrown.com/publications/article.asp?id=8881&nid=6. In order to remedy what was widely perceived as an unjustified tolling of the statute of limitations with regard to the taxpayer's entire return, newly enacted section 6501(c)(8)(B) provides that the extended limitations period for assessments applies only to the items that are related to the reporting failure, but only if such failure is due to reasonable cause and not willful neglect.

The technical correction in section 6501(c)(8)(B) is effective to returns filed after March 18, 2010, which is the original effective date of the HIRE Act's amendment to the assessment period under section 6501(c)(8).

Endnote

[1] Unless otherwise indicated, all references to "section" or "sections" herein are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "Code"), and all references to "Treas. Reg. §" are to regulations issued by the US Department of Treasury, as most recently adopted or amended as of the date hereof. All references to "IRS" are to the US Internal Revenue Service, and all references to "Treasury" are to the US Department of Treasury.

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