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International Taxation ??? Significant Changes to the Foreign Tax Credit and Other International Business Tax Provisions Enacted in The Education Jobs and Medicaid Assistance Act of 2010

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EXECUTIVE SUMMARY

On August 10, 2010, The Education Jobs and Medicaid Assistance Act of 2010[1] (the "Act") was signed into law by President Obama. The Act makes significant changes to the Internal Revenue Code of 1986, as amended (the "Code") that affect the availability and calculation of the foreign credits, as well as other important changes to the Code that affect the taxation of international business transactions. These changes generally are intended to ensure that the foreign tax credit claimed by taxpayers more closely corresponds to the related U.S. taxable income and to prevent certain sophisticated cross-border transactions which the Government believes produce inappropriate results. The Act also makes a technical correction to a provision affecting statute of limitations in connection with the reporting of certain foreign transfers.

Foreign Tax Credit. The Act's effects on the availability and calculation of the credit for foreign tax credit paid are as follows:

- ??? Enacts new Code Section 909[2], which creates a matching rule that applies when a U.S. taxpayer receives a credit for foreign taxes actually paid or deemed paid by a related party. The U.S. taxpayer's ability to take the credit for the foreign taxes paid or deemed paid by the related party will now be suspended until the time that such related foreign income is included in U.S. taxable income. This provision is generally effective for the taxable years beginning after December 31, 2010.
- ??? Denies a credit for foreign taxes paid that relate to items of foreign income that are not subject to U.S. tax as a result of "covered asset acquisitions," which include a variety of transactions in which the acquirer gets a step-up in the tax basis of the acquired foreign assets for U.S. tax purposes without a corresponding increase for

foreign tax purposes. Generally, this provision applies to transactions occurring after December 31, 2010 (with important safe harbors for certain transactions that have been either agreed to pursuant to a binding contract or disclosed to the IRS, the SEC or public accouncement, but not completed before December 31, 2010).

- ???Creates a new separate limitation category ("basket") for purposes of computing a taxpayer's foreign tax credit limitation under Section 904 for U.S. source income that has been "resourced" by a tax treaty (i.e., where the item would be treated as U.S. source under the Code, but is treated as foreign source by application of a tax treaty). This provision is generally effective for taxable years beginning after August 10, 2010 (the date of enactment).
- ???For purposes of the "deemed paid" credit for foreign taxes under Section 902, imposes a limitation on the amount of foreign taxes that a U.S. shareholder of a controlled foreign corporation ("CFC") will be deemed to have paid with respect to amounts treated as subpart F income as a result of CFC investments in United States property. This provision applies to acquisitions of U.S. property occurring after December 31, 2010.

In addition, the Act makes the following changes to the Code that affect the U.S. taxation of international transactions:

- ???Creates a new limitation on the use of a foreign acquiring corporation's earnings and profits in calculating the source of a deemed dividend resulting from related party acquisitionS of a foreign subsidiary (i.e., "hopscotching"). This provision applies to acquisitions occurring after August 10, 2010.
- ???Treats foreign corporations as "affiliated group members" for purposes of allocating interest expense among members of an affiliated group, if (a) at least 50 percent of the foreign corporation's gross income is income that is effectively connected to the conduct of a U.S. trade or business and (b) the foreign corporation would be an includible corporation for consolidated return purposes but for its foreign status. This provision is effective for taxable years beginning after August 10, 2010.
- ???Repeals, for taxable years beginning after December 31, 2010, and phases out for existing eligible corporations, the so-called "80/20 company" rules relating to the source of interest income and the exemption from U.S. withholding tax on all or a portion of dividends paid by corporations that meet the 80 percent foreign business requirement.
- ???Makes a technical correction to the scope of a statute of limitations that applies in connection with the failaure to report certain foreign transfers. This provision is effective as of the enactment date of the "HIRE Act," March 18, 2010.

The effect of many of these changes will depend on a taxpayer's individual circumstances, or upon the specific facts of a particular transaction. For more information about the application of these changes, please contact any of the lawyers listed on this Alert, or any member of the Proskauer Tax Group with whom you normally consult on these matters.

BACKGROUND

On August 5, 2010, the U.S. Senate passed H.R. 1586, and on August 10, 2010, the U.S. House of Representatives, in a special session, enacted H.R. 1586 as The Education Jobs and Medicaid Assistance Act of 2010. The Act was immediately transmitted to President Obama and signed into law.

The Act, which contains significant spending provisions, enacts a number of long-pending international tax provisions which were proposed in the Administration's General Explanations of the Administration's FY 2011 Revenue Proposals (the "Green Book") and which have been considered previously by Congress in various pieces of pending legislation prior to the Act, as well as a revenue-raising provision that eliminates the "advance earned income tax credit." The international tax provisions discussed in this memorandum change the availability and calculation of foreign tax credits pursuant to Code Sections 901-909 and 960 and change other Code sections affecting international transactions, and were enacted to offset the cost of the Act's spending provisions.

DISCUSSION

Foreign Tax Credit Splitting Events - New Code Section 909

Prior to the Act, there was no requirement that foreign taxes be "matched" with their associated U.S. taxable income in order to be creditable under Section 901 or to be eligible for the "deemed paid credit" of Section 902. Rather, foreign taxes generally were creditable under Section 901 when paid and were generally eligible for the deemed paid credit under Section 902 when dividends were paid by an eligible foreign corporation, in each case subject to the foreign tax credit limitation provisions of Section 904.

The Act creates new Section 909, which imposes a "matching" regime with respect to foreign taxes paid by one taxpayer where the related foreign income is (or will be) includible in U.S. taxable income by certain other taxpayers. Specifically, where there has been a "foreign tax credit splitting event," no credit is available for foreign taxes paid until the taxable year in which the foreign income is taken into account. A "foreign tax credit splitting event" occurs with respect to a foreign tax paid if the related income (the income to which a specific amount of foreign tax paid relates)[3] is or will be taken into account for U.S. federal income tax purposes by a "covered person" (i.e., the taxpayer claiming the credit is different from the taxpayer subject to the tax on the related income).[4] A "covered person" for Section 909 purposes means any entity in which the taxpayer paying the foreign tax holds, directly or indirectly, at least a 10 percent ownership interest; or which holds, directly or indirectly, at least a 10 percent interest in the taxpayer, as well as any person related to the taxpayer within the meaning of either Section 267(b) or Section 707(b).[5] The Treasury Department is granted the authority to expand the definition of "covered person" to include any other person that the Treasury Department so chooses to specify.[6] The Joint Committee on Taxation, in its technical explanation of the Act (the "JCT Explanation"),[7] states that this delegation of authority is to permit the Treasury Department to issue regulations treating as a "covered person" an unrelated counterparty in "transactions deemed abusive" (including certain sale-repurchase transactions).

With respect to partnerships, the matching rule of Section 909 will be applied at the partner level. Section 909 also will generally apply to S Corporations and trusts unless the Treasury Department specifies otherwise.[8]

The principles of this matching rule also will be applied to the "deemed paid credit" under Section 902.[9] Where a foreign income tax is not currently accounted for by reason of the Section 909 matching rule, such tax is taken into account in the taxable year in which any of the taxpayer or a domestic corporation that meets the ownership requirements with respect to a foreign corporation which is treated as eligible for the "deemed paid credit" (i.e., a "Section 902 corporation") includes the related income in determining its U.S. federal income tax liability. A collateral effect is that in determining the carryback and carryover of excess foreign tax credits under Section 904(c) (as well as the deduction for foreign taxes paid or accrued, and the extended period for claim of a credit or refund), foreign income taxes to which the provision applies are first eligible to be credited in the year in which the related foreign income is taken into account. As a result, foreign taxes deemed paid by a Section 902 corporation (including a CFC), and used in determining the earnings and profits of a foreign corporation, will not be taken into account until the taxable year in which the related income is taken into account, where there is a foreign tax credit splitting event.[10]

Section 909, as enacted, leaves numerous questions about its application unanswered, and includes a broad grant of regulatory authority to the Treasury Department to implement regulations to resolve such issues and otherwise implement the purposes of Section 909.[11] The Act grants the Treasury Department specific regulatory authority to define the application of the rule to hybrid instruments and to create exceptions from the application of Section 909.[12] The JCT Explanation also contemplates that the Treasury Department may issue rules on the treatment of losses and deficits in earnings and profits, as well as specific rules relating to deemed paid credits covering disregarded payments, group relief and other arrangements having similar effects.[13]

The JCT Explanation provides important guidance as to the intended limits of Section 909 in certain circumstances. The JCT Explanation states that it is not intended that differences in the timing of when income is taken into account for U.S. and foreign tax purposes should create a foreign tax credit splitting event where the same person pays the foreign tax but takes the related income into account in different taxable periods.[14] The JCT Explanation also states that no foreign tax credit splitting event is intended when a CFC pays or accrues a foreign tax and takes into account the related income in the same year even though the earnings and profits to which the foreign tax relates may be distributed as a dividend to, or included as subpart F income by, a "covered person." [15]

New Section 909 will apply to all creditable foreign income taxes paid or accrued in taxable years beginning after December 31, 2010.[16] With respect to the deemed paid credit, the provision will also apply to foreign income taxes paid by the relevant foreign subsidiary on or before December 31, 2010 if such taxes were not deemed paid under Section 902(a) or Section 960 prior to the effective date, but only for purposes of applying Section 902(a) and Section 960.[17]

Denial of Foreign Tax Credits in Certain Asset Acquisitions

Certain elections and transactions that can result in a basis increase for U.S. tax purposes without resulting in a corresponding basis increase for foreign tax purposes (for example, an election under Section 338(g) of the Code to treat a purchase of stock as a purchase of assets for U.S. tax purposes) can create items that give rise to a permanent basis difference vis-à-vis U.S. and foreign tax law. Such permanent basis differences can result in cost recovery deductions for U.S. tax purposes, reducing U.S. taxable income, and causing a permanent difference to arise between the foreign taxable income on which a potentially creditable foreign tax is imposed and the U.S. taxable income (or earnings and profits of a foreign corporation) upon which U.S. tax is (or ultimately will be) imposed.

The Act limits the availability of the credit for foreign taxes paid or deemed paid in respect of a "covered asset acquisition," which includes a "qualified stock purchase" treated as a purchase of assets under Section 338(a); a transaction treated as an asset acquisition for U.S. tax purposes and an acquisition of stock of a corporation (or disregarded) for foreign tax purposes; an acquisition of an interest in a partnership which has a Section 754 election in effect; and any other similar transaction identified by the Treasury Department.[18] Each of the specified transactions is in form an acquisition of interests in an entity (or treated as such for foreign tax purposes) in which the basis of the assets of such entity is increased to the fair market value of those assets for U.S. tax purposes without necessarily resulting in a corresponding basis increase for foreign tax purposes.

Section 901(m) denies a credit (including a deemed paid credit) for the "disqualified portion" of foreign taxes paid[19] in respect of a covered asset acquisition. The "disqualified portion" is the ratio of (i) the aggregate basis difference in all of the relevant foreign assets, (i.e., the aggregate basis step-up or step-down of such assets)[20] that results from the covered asset acquisition allocable to such tax year, divided by (ii) the foreign taxable income on which the foreign income tax is determined with respect to the relevant foreign assets in the covered asset acquisition.[21] The effect of the disqualified portion calculation is to deny credits for the portion of the foreign tax paid solely in respect of the stepped-up basis of the acquired assets.

The basis difference for any relevant foreign asset is generally allocated to each taxable year under the applicable cost recovery method for such asset.[22] However, the remainder of the basis difference not so previously allocated will be allocated to the taxable year in which there is a disposition of any relevant foreign asset.[23] Additionally, for purposes of Section 338 elections, the covered asset acquisition is treated as occurring at the close of the acquisition date for purposes of allocating the basis difference across taxable years.[24]

The Act grants regulatory authority to the Treasury Department to exempt foreign assets which have only a de minimis basis difference from the application of Section 901(m), as well as any other asset acquisitions where appropriate;[25] however, what constitutes a de mminimisbasis difference is not specified or clear.

The new provision will generally apply to covered asset acquisitions completed after December 31, 2010.[26] However, with respect to covered asset acquisitions in which the transferor and the transferee are unrelated parties, Section 901(m) will not apply so long as the acquisition was: (1) made pursuant to a written agreement which was binding on January 1, 2011 and at all times thereafter; (2) described in a ruling request submitted to the Internal Revenue Service on or before July 29, 2010; or (3) described on or before January 1, 2011 in a public announcement or in a filing with the Securities and Exchange Commission.[27]

Separate Limitation Category for Income Sourced by Treaty

In general, the amount of creditable foreign taxes is limited to the amount of U.S. tax liability on a taxpayer's foreign-source taxable income. This limitation is generally applied separately for foreign-source taxable income in two different categories ("baskets"): passive category income and general category income.[28] Various provisions of the tax treaties entered into by the U.S. result in certain categories of income being treated as foreign-source income, even though under the Code such income would be treated as U.S.-source, if the taxpayer is eligible for and avails itself of the benefits of such a treaty.

The Act creates a separate foreign tax credit limitation category (i.e., a new "basket") for these "resourced" items of income,[29] which means that the amount of creditable foreign taxes in respect of these items will be limited to the U.S. tax liability on resourced items of income. The provision also grants the Treasury Department authority to issue guidance providing that related items of income may be aggregated for purposes of applying the new basket. There are, however, two exceptions. First, the new basket does not apply to U.S.–owned foreign corporations which are subject to the special sourcing rule of the Code that treats certain foreign-derived income items of such corporations as U.S.-source, but are treated as foreign-source by application of a treaty. Second, the new basket similarly does not apply to amounts included in the special basket for gain and associated taxes resulting from the gain of certain stock or intangibles that are treated as U.S.- source under the Code but are treated as foreign-source by application of a treaty.

This provision is effective for taxable years beginning after the date of enactment.[30]

Limitation of Deemed Paid Credit for Section 956 Inclusions

The Act provides a new limitation on the amount of foreign taxes that a U.S. shareholder of a CFC will be deemed to have paid with respect to amounts includible in income as a result of CFC investments in U.S. property, pursuant to Section 956.[31] In general, a shareholder of a CFC is required to include in income amounts deemed repatriated by virtue of an investment in U.S. property ("Section 956 inclusions").

In general, a domestic corporation may be allowed a "deemed paid" credit for foreign income taxes paid by a foreign corporation and which, under the Code, the domestic corporation is deemed to have paid, but only when the related income is distributed or is included in the domestic corporation's income under the CFC rules, including Section 956 inclusions. The Act imposes a new limitation (in addition to existing limitations) on the availability of the deemed paid credit where a domestic corporation is required to take into account Section 956 inclusions.

Pursuant to the Act, a domestic corporation that is a U.S. shareholder in a CFC now determines the amount of foreign taxes it is deemed to have paid in each separate "basket" by comparing its foreign taxes deemed paid with respect to its Section 956 inclusions (the "tentative credit")[32] to a hypothetical amount of foreign taxes deemed paid as computed under the provision (the "hypothetical credit"). The hypothetical credit is the amount of foreign taxes deemed paid if cash in an amount equal to the Section 956 inclusion actually had been distributed through the chain of ownership that begins with the foreign corporation that holds the investment in U.S. property (i.e.,the investment giving rise to the Section 956 inclusion) and ends with the domestic corporation, applying the other foreign tax credit rules and limitations, but ignoring the effects of income and withholding taxes that would apply to an actual distribution of the cash. If the hypothetical credit is less than the tentative credit, then the amount of foreign taxes deemed paid with respect to the Section 956 inclusion is limited to the hypothetical credit; however, the amount of the tentative credit is not increased if the hypothetical credit would have been greater than the tentative credit. The limitation is applied basket-by-basket.

The JCT Explanation clarifies that the excess of the tentative credit over the hypothetical credit is intended to be treated the same as any other foreign tax, and thus such taxes are included in the computation of foreign taxes deemed paid with respect to a subsequent distribution from, or income inclusion with respect to, that foreign corporation, although any such subsequent distribution or inclusion would be subject to the normal limits applicable to the deemed paid credit, including this new provision.[33]

The Act requires the Treasury Department to issue regulations or guidance to carry out the purposes of the provision, including regulations that prevent the inappropriate use of the foreign corporation's foreign income taxes not deemed paid by reason of the provision (i.e., the amount of the excess of the tentative credit over the hypothetical credit) and the JCT Explanation notes that such guidance is expected to address attempted avoidance of the provision through a series of transactions.

This provision will apply to acquisitions of U.S. property, as defined in Section 956(c), occurring after December 31, 2010.[34]

New Anti-"Hopscotching" Rules for Certain Redemptions by Foreign Subsidiaries

The Act provides a special rule that alters the general rules relating to determining the amount of any deemed dividend resulting from certain acquisitions by a U.S. parent corporation of its related foreign subsidiary. In general, if one corporation acquires the stock of a related corporation in exchange for property, the acquisition is recharacterized as a redemption. If a deemed redemption is treated as a deemed distribution, it will be taxable as a dividend to the extent of the earnings and profits, first, of the acquiring corporation, and then of the target corporation, and to the extent that a deemed dividend is attributable to the earnings and profits of the acquiring corporation, the transferor is considered to receive the dividend directly from the acquiring corporation – bypassing the intermediary shareholders (a.k.a. "hopscotching").

The Act adds an additional limitation to the existing limitations on the use of a foreign acquiring corporation's earnings and profits. If a foreign corporation acquires stock of a parent corporation in return for property, and more than 50 percent of the dividends that would arise under Section 304 would not be subject to tax for the taxable year in which such dividends arise and would not be includible in the earnings and profits of a CFC, none of the earnings and profits of the foreign acquiring corporation will be used in determining the amount of any deemed dividend under Section 304. The effect of this rule is to further limit the "hopscotching" of foreign-source dividends that are not subject to U.S. withholding tax in this situation.

The new rule is effective immediately for all applicable stock acquisitions occurring after the date of enactment.[35]

Expanded Affiliated Group for Allocating Interest Expense

For purposes of the rules governing the allocation of interest expense among members of an affiliated group, the term "affiliated group" has generally been defined by the reference to the consolidated return rules, which excludes all foreign corporations. This has the effect of treating debt as fungible among members of an all-domestic affiliated group of corporations, but not among members of an affiliated group that includes both domestic and foreign corporations.

The Act amends the definition of an affiliated group for purposes of allocating interest expense, such that a foreign corporation will be treated as a member of an affiliated group if more than 50 percent of its gross income for the taxable year is income 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 the foreign corporation is owned, directly or indirectly, by members of the affiliated group.[36]

This provision is effective for taxable years beginning after the date of enactment.

Repeal of "80/20 Company Rules"

The Act repeals the so-called “80/20 company rules” that treat as foreign-source all or a portion of any interest paid by a resident alien individual or domestic corporation that meets the 80 percent active foreign business requirement test (an “80/20 company”) and that exempt from U.S. withholding tax all or a portion of any dividends paid by an 80/20 company.[37] The interest source and dividend withholding exemption rules for 80/20 companies are repealed by the Act for taxable years beginning after December 31, 2010.[38] However, a grandfather rule applies for any domestic corporation that (1) is treated as an 80/20 company for its last taxable year beginning before January 1, 2011 ("an existing 80/20 company”), (2) meets a new 80/20 test with respect to each taxable year beginning after December 31, 2010, and (3) has not added a substantial line of business with respect to such 80/20 company after the date of enactment of this provision. Pursuant to the grandfather rules, any payment of dividend or interest after December 31, 2010 by an existing 80/20 company that meets the three tests is exempt from withholding tax to the extent of the existing 80/20 company’s active foreign business percentage (as determined under the existing 80/20 company rules), but any payment of interest will be treated as U.S.-source income.[39]

In addition to the general effective date provisions, the repeal of the 80/20 company rules relating to the payment of interest does not apply to payments of interest to persons not related to the 80/20 company on obligations issued (taking into account the rules governing significant modifications of debt instruments) before the date of enactment.

Technical Correction to the HIRE Act Relating to Extension of Statute of Limitations for Failaure to Report Certain Foreign Transfers

The Act amends Section 6501(c)(8) to clarify that the tolling of the statute of limitations required under that section, where the taxpayer fails to file information returns with respect to certain foreign transfers, will apply to all the items on the return, in the absence of reasonable cause or if the failure results from willful neglect. However, where the taxpayer establishes reasonable cause, the statute of limitations will be tolled only for the item or items related to the failure to disclose such information. This technical correction is retroactive to the date of enactment of the HIRE Act (March 18, 2010).[40]

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[1] Pub. L. No. 111-226, 124 Stat. 2010.

[2] All Section references hereafter are to the Code, unless otherwise stated.

[3] Section 909(d)(3). For purposes of the deemed paid credit of Section 902, “related income” refers to the earnings and profits of the CFC.

[4] Section 909(d)(1). The definition of foreign income tax is identical to the amounts creditable as a foreign tax credit under Section 901(b)(1) for U.S. citizens and domestic corporations and the definition of a foreign income tax under Section 902(c)(4). Section 902(d)(2).

[5] Section 909(d)(4).

[6] *Id.*

[7] JCX-46-10, August 10, 2010.

[8] Section 909(c).

[9] Section 909(b).

[10] *Id.* "Foreign tax credit splitting event" has the same definition for Section 901 and Section 902 purposes.

[11] Section 909(e).

[12] *Id*.

[13] JCX-46-10, at 6.

[14] *Id*. at 5.

[15] *Id*.

[16] The Education Jobs and Medicaid Assistance Act of 2010 §211(c)(1).

[17] *Id*. § 211(c)(2).

[18] Section 901(m)(2). The deduction disallowance rules of Section 78 and Section 275 will not apply to any tax which is no longer creditable for foreign tax credit purposes under new Section 901(m).

[19] Foreign income tax is defined as any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States. Section 901(m)(5).

[20] The "basis difference" is generally defined as the excess of the adjusted basis of the asset immediately after the covered asset acquisition over the amount of the adjusted basis of the asset immediately before the covered asset acquisition. Section 901(m)(3)(C)(i). Where a covered asset acquisition results in a step-down in basis, because the property has a built-in loss, the amount of the loss is taken into account as a basis difference of a negative amount. Section 901(m)(3)(C)(ii).

[21] Section 901(m)(3)(A). However, if the taxpayer fails to substantiate such income to the satisfaction of the Treasury Department, the amount of income will be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction. *Id*.

[22] Section 901(m)(3)(B)(i).

[23] Section 901(m)(3)(B)(ii).

[24] Section 901(m)(3)(C)(iii).

[25] Section 901(m)(7).

[26] The Education Jobs and Medicaid Assistance Act of 2010 §212(b)(1).

[27] *Id*. Persons are treated as "related parties" for purposes of this exemption if the relationship between the parties is described in Section 267 or Section 707(b) of the Code.

[28] Section 904(d).

[29] Section 901(d)(6).

[30] The Education Jobs and Medicaid Assistance Act of 2010 §213(b).

[31] Section 960(c)(1).

[32] The tentative credit is determined without taking into account the effects of Section 960(c)(1). *Id*.

[33] JCX-46-10, at 24.

[34] The Education Jobs and Medicaid Assistance Act of 2010 §214(b).

[35] *Id*. §215(b).

[36] Section 864(e)(5).

[37] Section 861(a)(1).

[38] The Education Jobs and Medicaid Assistance Act of 2010 §217(d)(1).

[39] *Id.* §217(d)(2).

[40] *Id.* §218(b).

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