Tax

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Foreign Tax Credit Changes in P.L. 111-226

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On August 10, 2010, the President signed H.R. 1586 into law, P.L. 111-226 (the "Act"). The primary purpose of the Act is to authorize a transfer of roughly $26 billion to the States for education and Medicaid spending, but as part of its revenue offsets the Act makes several changes to the foreign tax credit provisions of the Internal Revenue Code (the "Code").

Foreign Tax Credit Splitting

New section 909 of the Code provides that, in certain circumstances, foreign income taxes paid or accrued are not taken into account for foreign tax credit purposes until the underlying foreign income is taken into account for U.S. federal income tax purposes. This rule applies both to U.S. taxpayers with their own foreign income and creditable foreign taxes (the "direct credit") and also to U.S. corporate taxpayers with "deemed" creditable foreign taxes arising under the foreign tax credit rules from dividends (or deemed dividends such as under subpart F) from foreign subsidiaries (the "indirect credit").

More specifically, the rule applies if there has been a "foreign tax credit splitting event," defined with reference to a foreign income tax as arising when the income (or, when appropriate, the earnings and profits) giving rise to that tax is or will be taken into account by a "covered person." With respect to the payor of a foreign income tax, a "covered person" is any entity in which the payor holds a ten percent or greater interest (by vote or value), any person holding, directly or indirectly, a ten percent or greater interest in the payor, any person bearing a relationship to the payor described in sections 267(b) or 707(b) of the Code and any other category specified by Treasury.

The basic thrust of this new provision is to prevent taxpayers from circumventing the foreign tax credit limitations (based generally on the amount of foreign and worldwide income in one of two categories or "baskets") through so-called "splitting" transactions with loosely related parties. It is not intended that there would be a splitting transaction simply because of differences in U.S. and foreign tax accounting rules where the same person pays a foreign tax but takes the related income into account for U.S. tax purposes in a different taxable period. In the case of partnerships, this new provision is to be applied at the partner level, and unless otherwise provided by Treasury, a similar approach applies to S corporations. Moreover, Treasury is given authority to apply the provision at the shareholder level in the case of regulated investment companies that elect under section 853 of the Code to treat foreign taxes paid by them as creditable by their shareholders. Treasury is also granted broad regulatory authority regarding, among other things, exceptions to application of the new provision and its application in the case of hybrid instruments (*e.g.,* instruments treated as equity for U.S. tax purposes but as debt for foreign tax purposes).

These foreign tax credit splitting rules are effective for foreign taxes paid or accrued after December 31, 2010. They also apply to foreign taxes paid or accrued prior to that date by foreign subsidiaries, but only for purposes of applying the indirect credit rules after December 31, 2010 (*e.g.,* in the case of a dividend paid or deemed paid by a foreign subsidiary after December 31, 2010 out of pre-January 1, 2011 earnings and profits). *Act, § 211, enacting I.R.C. § 909.*

Covered Asset Acquisitions

In many instances, the basis of foreign property held by a U.S. taxpayer or by a foreign subsidiary of a corporate U.S. taxpayer may be significantly higher for U.S. federal income tax purposes than it may be for foreign tax purposes. This result can occur, for example, when a U.S. corporate taxpayer purchases all the stock of a foreign corporation and then makes a section 338 election with respect to that purchase, thereby increasing the basis of the property held by the purchased foreign corporation, but only for U.S. federal income tax purposes. As the assets of that purchased foreign subsidiary are depreciated and when they are sold, the foreign income taxes of the subsidiary will be higher than they would have been had those foreign income taxes been computed based on the stepped-up asset basis arising solely under U.S. law.

The Act, in new section 901(m) of the Code, eliminates the U.S. foreign tax credit for foreign income taxes attributable to the lower basis for foreign tax purposes in the case of a "covered asset acquisition," defined as (i) a qualified stock purchase to which section 338(a) applies, (ii) any transaction that is treated as an acquisition of assets for U.S. federal income tax purposes but that is either treated as an acquisition of stock of a corporation or is disregarded for foreign tax purposes (*e.g.,* acquisition of a "hybrid" entity), (iii) any acquisition of a partnership interest in a partnership with a section 754 election in effect and (iv) any other transaction specified by Treasury. No foreign tax credit or deduction is allowed for the "disqualified portion" of foreign income taxes. The disqualified portion of foreign taxes with respect to a particular covered asset acquisition for a particular taxable year is the same percentage of foreign income taxes paid or accrued as the net basis step-up for U.S. federal income tax purposes (allocated among taxable years using the same cost recovery method as applies to the underlying assets for U.S. federal income tax purposes) bears to the income base for foreign income tax purposes for that taxable year.

New section 901(m) is effective for covered asset acquisitions occurring after December 31, 2010. Under a transition rule, the new rules do not apply to covered asset acquisitions between unrelated parties (i) pursuant to a written contract 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. *Act, § 212, enacting I.R.C. § 901(m).*

Separate Foreign Tax Credit Basket for Income Resourced under Treaty

In many instances, foreign income taxes can be imposed on income that is treated as U.S. source under federal income tax sourcing rules. For example, many jurisdictions impose their income tax on the sale of shares of corporations incorporated in the jurisdiction, even where the selling shareholder has no other connection with the jurisdiction. But the sourcing rules of section 865 of the Code will treat any gain from sale of those shares as U.S.-source in many, if not most circumstances. Treatment of the underlying income as U.S.-source makes it much less likely that a U.S. foreign tax credit will be available for the foreign income taxes imposed on the sale, because the foreign tax credit limitation is based on a comparison of foreign-source income to worldwide income. However, many U.S. income tax treaties provide that in these circumstances, to avoid double taxation, the U.S. taxpayer is allowed to treat the underlying income as foreign-source.

Treasury had become concerned that U.S. taxpayers were routing income through entities organized in treaty jurisdictions that imposed a relatively modest income tax on the income. As a result of resourcing the income as foreign source, and the fact that the U.S. foreign tax credit limitation now treats only two broad categories of income separately, the so-called "general income basket" and the "passive income basket," not only would the modest taxes imposed by the treaty jurisdiction be fully creditable, but additional foreign tax credits could become available.

The Act adds new section 904(d)(6) of the Code to provide that the foreign tax credit limitation is applied separately to any item of income (thus creating a separate basket for the item) if (i) without regard to a U.S. income tax treaty, the item would be U.S.-source, (ii) a treaty operates to recharacterize the item as foreign-source and (iii) the taxpayer has chosen to apply the treaty provision. Treasury is granted broad regulatory authority, including the ability to provide rules aggregating related items of income (*i.e.,* putting all such related items in one basket).

New section 904(d)(6) applies to taxable years beginning after the Act's date of enactment, August 10, 2010. *Act, § 213, enacting I.R.C. § 904(d)(6).*

Section 956 Inclusions

Under the subpart F rules, specifically section 956 of the Code, an incremental investment in U.S. property by a controlled foreign corporation (a "CFC") gives rise to a dividend directly from the CFC to its ultimate United States shareholders. Under the indirect foreign tax credit rules, the amount of foreign income taxes deemed paid by corporate United States shareholders of the CFC is based essentially on the effective foreign tax rate borne by the CFC. On the other hand, if the CFC is a lower-tier subsidiary, an actual dividend paid up through the corporate chain to an ultimate corporate United States shareholder would bring with it foreign taxes based on a blending of the effective foreign tax rates borne by the foreign corporations in the dividend-paying chain. Accordingly, a U.S. taxpayer can often achieve a better U.S. foreign tax credit result by having a lower-tier CFC make an investment in U.S. property than it can from having that CFC pay an actual dividend that is redistributed up the foreign corporate chain.

The Act eliminates this potential advantage. New section 960(c) of the Code provides that in the case of deemed dividends under section 956, the foreign income taxes brought along with the deemed dividend cannot exceed the amount of the foreign income taxes that would be brought along by an actual dividend up the foreign corporate chain.

New section 960(c) is effective for acquisitions of U.S. property occurring after December 31, 2010. *Act, § 214, enacting I.R.C. § 960(c).*

Certain Section 304 Transactions

Under section 304 of the Code a purchase of stock of a related corporation (the "target corporation") by another related corporation can be recharacterized as a distribution, treated as a dividend to the extent of relevant earnings and profits, directly from the purchasing corporation to the seller. In general, under section 304, the relevant earnings and profits are first those of the purchasing corporation and then those of the target corporation.

Treasury was concerned that application of the direct distribution rule could operate to avoid U.S. federal income taxes where the seller was a foreign person, the purchasing corporation was a foreign person, but the seller owned the purchasing corporation through a chain that included a U.S. corporation. Earnings and profits deemed distributed directly from the purchasing corporation to the seller by operation of section 304 could escape U.S. taxation, while a series of dividends up the chain and through an intervening U.S. corporation could not.

New section 304(b)(5)(B) of the Code provides that the earnings and profits of a foreign purchasing corporation are not taken into account under section 304 if more than 50 percent of the dividends arising from the section 304 transaction (i) would not be subject to U.S. federal income taxation in the taxable year in which the dividend arises and (ii) would not be included in the earnings and profits of a CFC.

This provision is effective for acquisitions occurring after the date of the Act's enactment, August 10, 2010. *Act, §215, enacting I.R.C. § 304(b)(5)(B).*

Interest Allocation Rules

The foreign tax credit limitation depends heavily on the numerous sourcing rules contained in the Code. Among the more complex of those rules is a set of provisions governing the allocation of interest expense between foreign and domestic sources. Under these provisions, an affiliated group is treated as a single person and allocation of the group's interest expense is based on the location (foreign or domestic) of the group's assets. While foreign corporations are excluded from affiliated groups, existing Treasury Department regulations provide that a foreign corporation is included in the group for interest allocation purposes if (i) more than 50 percent of its gross income for the taxable year is effectively connection with the conduct of a trade or business within the United States ("ECI") and (ii) at least 80 percent of either the vote or value of its stock is owned by members of the affiliated group.

The existing Treasury Department regulations also provide that for foreign corporations included in an affiliated group for interest allocation purposes, all of the foreign corporation's assets and interest expense are taken into account if 80 percent or more of the foreign corporation's gross income is ECI for the taxable year, but only a portion of those assets and that expense is taken into account if that ECI percentage is between 50 and 80 percent.

The Act amends section 864(e)(5)(A) of the Code, effective for taxable years beginning after the date of the Act's amendment, August 10, 2010, to provide that any foreign corporation meeting the 50 percent ECI and 80 percent ownership tests is part of the affiliated group; thus all of that foreign corporation's assets and interest expense will be taken into account for interest allocation purposes regardless of the foreign corporation's ECI percentage. *Act, § 216, enacting I.R.C. § 864(e)(5)(A).*

Repeal of 80/20 Taxpayer Provisions

In general, for U.S. federal income tax purposes, interest paid by U.S. persons and dividends paid by U.S. corporations are treated as U.S. source income. For non-U.S. persons, U.S.-source interest (other than "portfolio interest" and interest on certain bank deposits) and dividends are subject to a flat 30 percent gross income tax (which may be reduced or eliminated under an applicable U.S. income tax treaty) that is enforced and collected by requiring withholding by the payor of the interest or dividends.

An exception exists for U.S. persons that derive at least 80 percent of their gross income from all sources from the active conduct of a trade or business in a foreign country and from non-U.S. sources ("80/20 taxpayers"). Interest paid to unrelated parties by 80/20 taxpayers is treated as non-U.S. source. Interest paid to related parties by 80/20 taxpayers is treated as non-U.S. source in the same percentage as the payor's percentage of total gross income that is comprised of non-U.S. source income during a specified testing period. Dividends paid by corporate 80/20 taxpayers are exempt from U.S. withholding tax, but are nonetheless treated as U.S. source.

The Act repeals the 80/20 taxpayer rules, effective for taxable years beginning after December 31, 2010. There is an extensive grandfather rule for existing 80/20 taxpayers; under this rule the "active foreign business percentage" of interest and dividends paid by qualifying 80/20 taxpayers would remain exempt from U.S. withholding tax, but would nonetheless be treated as U.S.-source income. And the repeal of the 80/20 taxpayer provisions will not apply to payments of interest to unrelated parties on any debt obligation issued prior to the Act's date of enactment, August 10, 2010. Any significant modification of a debt instrument (including any extension of the term of the instrument) is treated as a new issue. Note that "any extension of the term" is a stricter standard for extensions than is provided under Income Tax Regulations section 1.1001-3(e)(3), dealing with reissuance of debt obligations generally. *Act, § 217, deleting I.R.C. § 861(a)(1)(A).*

Statute of Limitations

Under the 2010 HIRE Act (P.L. 111-147, § 513), the normal three-year statute of limitations is extended for all items on a taxpayer's return if a taxpayer's omission from gross income is attributable to foreign assets required to be reported to the Internal Revenue Service. The Act amends section 6501(c)(8) of the Code to provide that if the failure to provide required information is due to reasonable cause and not to willful neglect then the statute of limitations is extended only with respect to the items related to the failure. This provision is effective as if included in the HIRE Act provision. *Act, § 218, amending I.R.C. § 6501(c).*

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the author below.

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