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Bill Passes with International Offsets H.R. 1586

On August 11, 2010, President Obama signed a Senate substitute amendment to H.R. 1586 (Education Jobs and Medicaid Assistance Act of 2010). The amendment is funded largely by restricting the ways in which multinational corporations claim the foreign tax credit.

The revenue offsets in the amendment have been in prior bills that have failed to make it to the President's desk, including the Investing in American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 5893) and the American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213). While some in Congress call these "tax loopholes," others argue that these tax provisions will negatively impact U.S. multinational companies and increase the cost of doing business for companies during a recession. Most of the provisions will apply to taxable years beginning after December 31, 2010. The remaining provisions will apply after the date of the enactment of the legislation.

Rules to Prevent Splitting Foreign Tax Credits from the Income to Which They Relate

This provision will implement a matching rule that suspends the recognition of foreign tax credits until the related foreign income is taken into account for U.S. tax purposes. As might be expected, it is considerably more complex than this description implies, but the thrust of the change is consistent with a general movement toward diminishing cross-crediting of foreign taxes against unrelated income, and what is thought to be excessive use of the foreign tax credit.

Denial of Foreign Tax Credit with Respect to "Covered Asset Acquisition"

The amendment identifies three cases in which a U.S. taxpayer can obtain an asset basis step-up in purchased business assets, but generally there is no asset basis step-up for foreign tax purposes (and generally no foreign or U.S. tax will be paid to justify the basis step-up): (1) a foreign section 338 election; (2) purchase of an entity that is not a corporation for U.S. purposes, but is a corporation for foreign tax purposes; and (3) acquisition of an interest in a partnership as to which a section 754 election has been made ("covered asset acquisitions"). Because of the step-up in basis for U.S. tax purposes, depreciation for U.S. tax purposes exceeds depreciation for foreign tax purposes. Thus, the U.S. taxable base is lower than the foreign taxable base. As a result, the foreign jurisdiction's income, with respect to which the foreign tax credit is generated, will be greater than the income recognized for U.S. purposes, and the foreign tax credits that are generated could be used to offset U.S. taxes on other foreign income. The amendment effectively will prevent taxpayers from claiming the foreign tax credit with respect to foreign income that would not have been taxed abroad if the asset basis step-up had been respected for foreign tax purposes.

Separate Application of Foreign Tax Credit Limitation to Items Resourced Under Treaties

This provision addresses transfers of ownership of income-producing assets to foreign branches and disregarded entities of a U.S.-based multinational. Income from such property is often lightly taxed on a net basis by the foreign country, but treaties generally categorize such income generated as foreign source. This artificially inflates the taxpayer's foreign source income and

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Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300
Fax: 202.756.3333

www.alston.com

allows the taxpayer to use foreign tax credits to reduce taxes on foreign source income beyond the maximum amount of U.S. tax that could be imposed on such income. The act abides by the treaty commitment to treating income as a foreign source, but segregates the income so that it is not the basis for claiming foreign tax credits that have nothing to do with double taxation.

Limitation on the Amount of Foreign Taxes Deemed Paid with Respect to Section 956 Inclusions

If a foreign subsidiary with a relatively high tax expense distributes a dividend up through a chain of companies, the foreign tax credit on the dividend ultimately received by the U.S. shareholder normally is a blend of the tax rates of each foreign subsidiary in that chain, although section 956 allows a taxpayer to deem a dividend from a foreign subsidiary directly to the U.S. shareholder in certain circumstances. This can result in increasing the credit. The act will limit the amount of foreign tax credits that may be claimed on a deemed dividend under section 956 to the amount that will have been allowed with respect to an actual dividend.

Special Rule with Respect to Certain Section 304 Sandwich Redemptions

This provision addresses a technique in which a foreign-based multinational corporation sells stock in a U.S. subsidiary to the latter's foreign subsidiary (hence a sandwich structure) and Section 304 applies to require the foreign seller to receive a dividend from the foreign buyer, thus reducing its earnings and profits, without any U.S. taxation of the dividend. This result allowed the foreign subsidiary's earnings and profits to completely—and permanently—bypass the U.S. tax system. The amendment will eliminate this type of tax planning by preventing the foreign subsidiary's earnings from being reduced and, as a result, the earnings will remain subject to U.S. tax (including withholding tax) when ultimately repatriated to the foreign parent corporation as a dividend.

Modification of Affiliation Rule for Purposes of Rules Allocating Interest Expense

The act will prevent taxpayers from using certain techniques to minimize the amount of foreign source interest expense, and thereby boost foreign source income—thus allowing taxpayers to utilize more foreign tax credits. The amendment's method is to include certain foreign subsidiaries in the U.S. affiliated group for purposes of allocating the deductions. The act also modifies the affiliation rules to strengthen these anti-abuse rules.

Termination of 80/20 Rule

Under current law, dividends and interest paid by a domestic corporation are U.S.-source income to the recipient and subject to gross basis withholding tax if paid to a foreign person unless at least 80 percent of a corporation's gross income during a three-year period is foreign source income and is attributable to the active conduct of a foreign trade or business (an "80/20 company"). Furthermore, interest received from an 80/20 company can increase the foreign source income of, and therefore the amount of foreign tax credits that may be claimed by, a U.S. multinational company. The act will repeal the 80/20 company rules (and the 80/20 rules for interest paid by resident alien individuals). The amendment will include relief for existing 80/20 companies that meet specific requirements and that are not abusing the 80/20 company rules.

Technical Correction to Statute of Limitations Provision in the HIRE Act

The act will make a technical correction to the foreign reporting and withholding tax compliance provisions with respect to ownership of foreign assets legislated under the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147) to clarify the circumstances under which the statute of limitations will be tolled for corporations that fail to provide certain information on cross-border transactions or foreign assets. Under the technical correction, the statute of limitations period will not be tolled if the failure to provide such information is shown to be due to reasonable cause and not willful neglect.

For more information, please contact Tola Ozim at 212.210.9533 and Edward Tanenbaum at 212.210.9425.

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International Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

John F. Baron
704.444.1434

Henry J. Birnkrant
202.756.3319

Robert T. Cole
202.756.3306

Phillip C. Cook
404.881.7491

James E. Croker, Jr.
202.756.3309

Jasper L. Cummings, Jr.
919.862.2302

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Brian D. Harvel
404.881.4491

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Brian E. Lebowitz
202.756.3394

Clay A. Littlefield
704.444.1440

Tola Ozim
212.210.9533

Vivek Patel
404.881.7686

Timothy J. Peaden
404.881.7475

Matthew A. Stevens
202.756.3553

Gerald V. Thomas II
404.881.4716

Charles W. Wheeler
202.756.3308