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The American Jobs and Closing Tax Loopholes Act of 2010 - International Proposals

On Friday, May 28, 2010, the U.S. House of Representatives passed the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213 (the "Bill"). The Bill extends several short-term tax breaks that are soon set to expire. In order to offset the cost of the extensions, the Bill includes significant revenue raisers targeted at closing foreign tax loopholes and curtailing abuses of the U.S. foreign tax credit system. The Senate Finance Committee is in the process of considering the Bill and may propose amendments.

Prevention of Foreign Tax Credit Splitting

New section 909 would attack the separation of creditable foreign taxes from associated foreign income. Under the new provision, when this sort of foreign splitting event occurs, the foreign tax will not be taken into account for foreign tax credit purposes until the related income is recognized for U.S. tax purposes by a "covered person." This has been termed the "matching rule." This provision would be effective for foreign income taxes paid or accrued after May 20, 2010.

Denial of Foreign Tax Credits for Covered Asset Acquisitions

New section 901(l) denies foreign tax credits to the extent they relate to tax basis differences resulting from a "covered asset acquisition." The provision targets any transaction in which the tax basis of an asset is increased for U.S. tax purposes, but not for foreign tax purposes—for example, when a section 338 election is made with respect to the acquisition of a foreign corporation. 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, would 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. This provision would be effective for covered asset acquisitions between related parties after May 20, 2010, and, in all other cases, would be effective on the date of enactment.

Separate Foreign Tax Credit Limitations on Resourced Items

Section 904(d)(6) would be amended so that, in any case where a treaty transforms U.S.-source income into foreign-source income, the foreign tax credit limitation on the use of foreign tax credits is applied separately to each such item. This is intended to prevent taxpayers from shifting ownership of U.S. income-producing assets from U.S. entities to foreign entities in foreign countries where the income may be taxed lightly, but under a treaty, categorized as foreign source. As a result, the taxpayer has the ability 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. This provision would be effective for taxable years beginning after the date of enactment.

Limitation on Deemed Payment of Foreign Taxes on Section 956 Inclusions

Under section 956, when a controlled foreign corporation (CFC) invests in U.S. property, the CFC is deemed to have paid a dividend directly to the U.S. parent. In some cases, if the CFC had paid the dividend directly up the chain, a lower amount of foreign taxes would have been creditable, whereas the deemed payment by the CFC under section 956 is said to have "hopscotched" over the intervening

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entities. By taking advantage of this hopscotch rule, the foreign tax credit on the deemed dividend can be greater than the foreign tax credit would be on an actual dividend. New section 960(e) would limit the amount of foreign tax credits that may be claimed for a deemed dividend to the amount that would be allowed for an actual dividend with respect to any section 956 inclusion. This provision would be effective for acquisitions of U.S. property made by CFCs after May 20, 2010.

Redemption of U.S. Entity by Foreign Subsidiary

New section 304(b)(5)(B) would eliminate a tax-planning technique that allows the earnings of foreign-based multinationals (e.g., a foreign-based company that owns a U.S. company that, in turn, owns a foreign subsidiary) to bypass the U.S. tax system. If the foreign subsidiary's earnings are paid up through the U.S. subsidiary to the foreign parent, a U.S. tax applies to the dividend paid to the U.S. subsidiary, and a withholding tax applies to the dividend paid by the U.S. subsidiary. To avoid this withholding tax, the foreign parent could sell stock of its U.S. subsidiary to the foreign subsidiary. Under section 304, this would draw up earnings and profits (E&P) directly from the foreign subsidiary, and the E&P would avoid U.S. tax. Under the Bill, if a section 304 acquisition occurs, and the acquiring corporation is a foreign corporation, no E&P would be taken into account under the normal section 304 rules if more than 50 percent of the dividends that would otherwise arise under section 304 would either not be subject to tax in the year the dividends arise, or would not be included in the E&P of a CFC. Accordingly, the foreign subsidiary's E&P are not reduced, and they remain available to be taxed in the United States. The provision would be effective for acquisitions after May 20, 2010.

Inclusion of Foreign Corporations in Affiliated Groups for Interest Expense Allocation

Lawmakers are worried that multinational corporate groups shift interest expenses to minimize the amount of foreign source interest expense in order to boost foreign source income. For purposes of allocating the interest deduction, not all affiliated foreign corporations are taken into account. Section 864(e)(5)(A) is amended to make a foreign corporation part of an affiliated group for purposes of the interest allocation regulations if more than 50 percent of the foreign corporation's gross income is effectively connected with a U.S. trade or business, and at least 80 percent (vote or value) of the foreign corporation is owned by members of the affiliated group. Under the current regulations, if between 50 and 80 percent of the foreign corporation's income is effectively connected income, only a portion of the assets would be taken into account for purposes of allocating the interest deduction. This provision would apply to taxable years beginning after the date of enactment.

Repeal of the 80/20 Rules

Section 861(a)(1)(A), the so-called 80/20 rule for companies (as well as for interest paid by resident alien individuals), would be repealed. Under the 80/20 rule, dividends and interest paid by a domestic corporation with at least 80 percent foreign source gross income are treated as foreign source. Accordingly, they are not subject to withholding and could be treated as foreign-source income for purposes of the foreign tax credit. The repeal was prompted by perceived abuses by some 80/20 companies. In order to provide relief for certain existing 80/20 companies, there are six pages of grandfathering rules associated with this repeal. The provision would apply to taxable years beginning after December 31, 2010.

Sourcing Rules for Guarantee Fees (Reversal of Container Corp.)

Section 861(a)(9) would source guarantee fees like interest, which is sourced by reference to the country of residence of the payor, so that guarantee fees paid by a U.S. resident would be U.S. source (and subject to withholding when paid to a foreign entity). Congress is concerned that, if guarantee fees are sourced like services, U.S. subsidiaries of foreign corporations could pay deductible guarantee fees (not subject to withholding tax) to foreign affiliates, which is viewed as an income-stripping transaction. This provision reverses the result in *Container Corp. v. Commissioner*, 134 T.C. No. 5 (Feb. 17, 2010). This provision would apply with respect to guarantees issued after the date of enactment.

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