E-ALERT | Tax

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THE AMERICAN JOBS AND CLOSING TAX LOOPHOLES ACT OF 2010 - EXPECTED AND UNEXPECTED INTERNATIONAL PROPOSALS

The House Ways and Means Committee and the Senate Finance Committee today introduced a summary of the long awaited tax extenders bill, titled the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213. Legislative language is to be introduced shortly. The bill would extend many of the tax provisions that otherwise expired on January 1 of this year, including, for example, the section 954(c)(6) subpart F look-thru rule.

Many of the "Loophole Closers" included in the bill as revenue offsets would modify existing international tax provisions related to the foreign tax credit, subpart F, and repatriation. Some of these provisions were expected, many were unexpected, including one provision that would reverse a recent Tax Court case involving the sourcing rules for guarantee fees. The international tax "Loophole Closers" described in the summary are discussed below.

SPLITTER TRANSACTIONS

Current law generally provides a credit for foreign taxes imposed on income even if the US taxpayer claiming the credit does not take into account the income subject to the foreign tax. This provision, also included in the Obama Administration's FY 2011 Budget, requires a matching of foreign income with the foreign tax credit. It would suspend the recognition of foreign tax credits until the related foreign income is taken into account for US tax purposes. The substance of the provision is similar to regulations proposed by the IRS and Treasury in 2006, but never finalized. The regulations reportedly were delayed due to concern that the proposed treatment in the regulations of foreign "reverse hybrids" (foreign entities treated as pass-throughs for foreign tax purposes, but as corporations for US tax purposes) actually could facilitate certain "credit-splitting" transactions. The proposal effectively would codify the proposed regulations and would apply to all "split" foreign taxes claimed by the taxpayer after the date the bill is introduced.

COVERED ASSET ACQUISITIONS

US taxpayers that acquire foreign corporations and make an election under section 338(g) or that acquire foreign hybrid entities can treat the acquisition as an asset acquisition rather than a stock acquisition for US tax purposes. These transactions typically are treated as stock acquisitions for foreign tax purposes. As a result, the US taxpayer typically can obtain a cost basis in the assets of

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the target for US tax purposes even though no such step-up is available for foreign tax purposes. The target's stepped-up cost basis in its assets reduces over time its earnings pool for US tax purposes through depreciation deductions that are larger under US law than under foreign law. The result over time is a large (or "hyped") foreign tax pool for the target, relative to the target's earnings pool. When the target subsequently distributes its earnings, the US taxpayer may include a relatively small amount of dividend income and obtain a relatively large accompanying foreign tax credit. The provision in the bill would deny the foreign tax credit attributable to foreign income that is offset by the increased depreciation deductions resulting from treatment of the initial acquisition as an asset acquisition for US tax purposes. The provision would apply to related party transactions occurring after the date the bill is introduced, and unrelated party transactions occurring after the date of enactment.

RESOURCED INCOME UNDER TAX TREATIES

A number of US tax treaties allow US taxpayers to reclassify income as foreign source if the treaty allocates to the treaty partner the right to tax the income. Under the foreign tax credit limitation, however, the reclassified item of income may be subject to a separate foreign tax credit limitation if it is earned through a "United States-owned foreign corporation." According to the description of this provision, a number of taxpayers have circumvented this special separate limitation by transferring assets that produce income subject to the treaty reclassification rule to entities that are not "US owned foreign corporations" (e.g., branches, partnerships, etc.). The structure is intended to increase the US taxpayer's foreign source income and thus its ability to claim the foreign tax credit. The provision would continue to treat the income in question as foreign source but would impose a separate limitation in taxable years beginning after the date of enactment.

SECTION 956 "HOPSCOTCH RULE"

US taxpayers may structure their foreign operations under a holding company in a low tax jurisdiction, for example, to facilitate cash management among foreign operations. This structure can make a repatriation of funds from the foreign group tax-inefficient. For example, distributions from high-tax subsidiaries of the foreign holding company up through the chain may become diluted while passing through the holding company's low-tax pool. One longstanding mechanism for preventing this type of dilution has been to make affirmative use of the anti-deferral rule in section 956 and cause a deemed distribution of the high-tax subsidiary's earnings directly to the US taxpayer. The provision would limit, after the date of enactment, the amount of the deemed-paid foreign tax credit the US taxpayer can claim in such cases to the (diluted) amount it would have obtained if the high-tax subsidiary had distributed its earnings up through the chain of ownership rather than "hopscotching" over the holding company. It is unclear how the provision would redetermine the earnings and tax pools of the foreign subsidiaries in question.

REDEMPTIONS BY FOREIGN SUBSIDIARIES

This provision is aimed at "domestic sandwich" structures: a foreign multinational owns a US subsidiary that owns a foreign subsidiary. Under current section 304, the foreign parent's sale of the stock of the US subsidiary to the foreign subsidiary is treated as a deemed dividend directly from the foreign subsidiary to the foreign parent, bypassing US taxation. Under the bill, a foreign subsidiary that enters into such a transaction would not be permitted to reduce its earnings. The earnings would remain subject to US taxation, including US withholding tax, when repatriated to the foreign parent corporation as a dividend. The provision would apply to acquisitions after the date the bill is introduced. The scope of this provision is unclear. Domestic sandwich structures are generally

disfavored, and the provision may be expected to discourage further foreign multinationals from holding foreign assets under their US subsidiaries.

ALLOCATING INTEREST EXPENSE

Treasury regulations under section 861 require that foreign subsidiaries with a significant amount of US source income be treated as part of the US group for purposes of calculating the foreign tax credit limitation and allocating interest expense. The summary indicates that taxpayers have utilized the current rules to their advantage. The bill would change the affiliation rules to prevent future abuse for taxable years beginning after the date of enactment. The summary does not provide any further details concerning the scope and operation of the provision.

REPEAL OF 80/20 RULES

Section 861 currently permits dividends and interest paid by a US corporation that earns at least 80 percent of its gross income over a three-year period from the active conduct of a foreign trade or business to be excluded from the withholding rules. The bill would repeal this rule (and a similar rule for resident alien individuals), effective for the 2011 taxable year, but would provide relief for certain 80/20 companies that meet specific anti-abuse rules.

SOURCE OF GUARANTEES

The source of a guarantee for tax purposes has been subject to uncertainty for many years. Recently, the IRS has gravitated toward the position that guarantees are sourced by the residence of the payor, in a manner similar to interest. However, the Tax Court recently ruled in *Container Corp. v. Commissioner*, 134 T.C. No. 5 (2010), that guarantee fees should be sourced as a service, based on the location where the services are performed. The bill would reverse this decision and would provide that guarantees issued after the date of enactment are sourced to the location of the payor, in a manner similar to interest. The provision is not intended to effect the treatment of guarantees issued before enactment.

CORRECTION TO STATUTE OF LIMITATIONS IN HIRE ACT

The HIRE Act made amendments to Section 6501(c)(8) which potentially toll the statute of limitations, indefinitely, for a taxpayer's entire return if the taxpayer fails to properly file certain forms related to cross-border transactions. The bill would make technical corrections to the provision to clarify that the statute will not be tolled if the failure to comply with the filing requirements is due to reasonable cause and not willful neglect.

BOOT-WITHIN-GAIN LIMITATION

The amount of gain a taxpayer must recognize on boot in connection with a tax-free reorganization is limited under current law to the amount of gain realized in the exchange (the "boot-within-gain" rule). A sale of the stock of a foreign subsidiary to another foreign subsidiary for cash, followed by a liquidation of the target subsidiary, qualifies as a valid "D reorganization." Under current law, therefore, the boot-within-gain limitation allows the US taxpayer to receive cash from a foreign subsidiary that acquires a high-basis target subsidiary for cash in a D reorganization. The bill would repeal the boot-within-gain limitation for those reorganizations (both domestic and cross-border) if the effect of the transaction is the distribution of a dividend. Subject to a transition rule, the provision would apply to those transactions occurring after the date of enactment.

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