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House Targets International and Domestic Tax Planning Strategies

Today the House passed H.R. 4213, "American Jobs and Closing Tax Loopholes Act of 2010." The bill contains both new proposals and proposals that were included in the Administration's Fiscal Year 2011 budget. The bill's proposal on carried interest is summarized in our previous client memorandum dated May 21, 2010, *Update on "Carried Interest" Legislation*, except that the carried interest proposal would be effective beginning with taxable years ending after December 31, 2010. The bill also contains a number of foreign and corporate tax provisions. Select proposals are described below.

Rules To Prevent Foreign Tax Credit Splitting

To prevent the splitting of foreign tax credits from the "related" foreign income (for example, in the case of certain "hybrid" arrangements), the bill includes a provision that would delay the recognition of foreign tax credits until the related income is taken into account for U.S. tax purposes. This suspension rule would apply when there has been a "foreign tax credit splitting event," which occurs when one person pays the foreign income tax and another person, related to the payor of the foreign taxes (including through a 10% ownership interest, by vote or value), takes the income into account under U.S. law. In such case, the foreign taxes will not be taken into account by the taxpayer until the related income is also taken into account by the taxpayer for U.S. federal income tax purposes. Similar rules apply (both for purposes of indirect foreign tax credits and for purposes of determining earnings and profits) in the case of foreign taxes paid by a foreign subsidiary of a U.S. corporation. The bill provides Treasury with broad regulatory authority, including to address exceptions to the rules and the proper application of these rules to hybrid instruments. The provision would apply to foreign taxes paid or accrued after May 20, 2010 and to foreign taxes paid or accrued prior to that date for purposes of applying the indirect foreign tax credit rules after such date.

Denial of Foreign Tax Credits with Respect to Asset Basis Step-up Transactions

The bill would limit U.S. taxpayers' ability to claim foreign tax credits when engaging in certain acquisitions that result in a tax basis step-up for U.S. federal income, but not foreign, tax purposes (a "covered asset acquisition"). A covered asset acquisition is (a) a stock purchase for which there has been a section 338 election, (b) any transaction that is treated as an asset acquisition for U.S. federal income tax purposes but that is either disregarded or treated as an acquisition of stock of a corporation under the relevant foreign income tax law (*e.g.*, an acquisition of an interest in a "hybrid" entity), (c) an acquisition of a partnership interest where the partnership has a section 754 election in effect, or (d) pursuant to administrative guidance, any other similar transaction. Because a covered asset acquisition does not affect the earnings of the foreign subsidiary for purposes of calculating the foreign tax base, a covered asset acquisition may result in higher taxable earnings for foreign tax purposes than for U.S. federal income tax purposes. In order to prevent taxpayers from crediting foreign taxes attributable to this difference in the tax bases against U.S. taxes imposed on unrelated foreign source income, the bill would disqualify a portion of any foreign taxes determined with respect to income or gain attributable to assets for which there is a step-up in basis. The disqualified portion of the foreign taxes generally is determined based on the ratio of (a) the aggregate step-up in tax basis allocable to a taxable year (allocated using the applicable cost recovery method, with any remainder of a basis step-up allocated to the year of the asset's disposition), over (b) the foreign taxable income on which the foreign tax is based. If a covered asset acquisition involving built-in loss assets results in a step-down for U.S. tax purposes, the U.S./foreign difference attributable to the step-down may be netted against basis step-up from other covered asset acquisitions in calculating the disqualified portion of the foreign taxes. The

bill permits Treasury to issue regulations, including to exempt certain covered asset acquisitions with respect to which there is a minimal basis difference. The disqualification would apply, with certain grandfathering exceptions, to covered asset acquisitions between unrelated transferors and transferees occurring after the date of the bill's enactment, and to covered asset acquisitions between related transferors and transferees occurring after May 20, 2010.

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

The bill provides that the direct and indirect foreign tax credit provisions will be applied separately (in a new "basket") with respect to each item of income that would be U.S. source but for the taxpayer choosing the benefits of a U.S. treaty that treats such item as foreign source. This provision is in response to a concern that taxpayers are shifting income-producing assets from U.S. corporations to foreign disregarded entities located in treaty jurisdictions, with the result that the foreign jurisdiction taxes the associated income at low rates and the taxpayer is permitted to treat the entire amount of the income as foreign source under the applicable treaty. The bill allows Treasury to issue regulations, including regulations which provide that related items of income may be aggregated for purposes of these rules. The provision would apply to taxable years beginning after the date of the bill's enactment.

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

If a U.S. corporation includes an amount in income under section 956 because a lower-tier controlled foreign corporation has made an investment in U.S. property, the U.S. corporation is treated as if it received a direct dividend from the lower-tier subsidiary (and, for foreign tax credit purposes, is deemed to have paid foreign taxes paid by such subsidiary). Thus, under current law, the dividend (and the associated foreign taxes) "hopscotch" over any upper-tier foreign corporations that reside in the chain between the lower-tier controlled foreign corporation and the U.S. corporation, avoiding a blending of tax rates with any such foreign corporations that are located in low-tax jurisdictions. The bill prevents this result by providing that the amount of foreign taxes deemed paid by a U.S. corporation with respect to any section 956 inclusion will not exceed the amount of foreign taxes that would have been deemed paid if the amount of such inclusion was distributed in cash through the chain of entities to the U.S. corporation (determined without regard to any foreign taxes that would have been imposed on an actual cash distribution). Treasury is directed to issue such regulations as are necessary or appropriate to carry out the purposes of these rules, including to prevent the inappropriate use of the foreign income taxes not deemed paid. This provision would apply to acquisitions of U.S. property after May 20, 2010.

Certain Redemptions by Foreign Subsidiaries

Under section 304, a sale of stock between related parties may be treated as a deemed distribution instead of a sale for U.S. federal income tax purposes. For example, if a parent corporation ("Parent") sells stock of its first-tier subsidiary ("Issuing Sub") for cash to a subsidiary of Issuing Sub ("Acquiring Sub"), the transaction generally would be treated as a distribution of cash from Acquiring Sub to Parent. In general, the distribution would be treated as a dividend first to the extent of the earnings and profits of Acquiring Sub and then to the extent of the earnings and profits of Issuing Sub. The bill would modify section 304 for certain transactions involving a foreign acquiring corporation (i.e., Acquiring Sub in the above example). Under this provision, the foreign acquiring corporation's earnings and profits would not be taken into account for purposes of applying section 304 if more than 50% of the deemed dividend would not (i) be subject to federal income tax in the year of the stock sale or (ii) be includible in the earnings and profits of a controlled foreign corporation. The provision is designed to prevent a direct deemed dividend from a foreign lower-tier subsidiary (Acquiring Sub) to a foreign parent corporation that bypasses a U.S. upper-tier subsidiary (Issuing Sub). The earnings and profits would remain preserved in the Acquiring Sub, and therefore would be subject to subsequent inclusion by the U.S. upper-tier subsidiary. This provision would be effective for acquisitions after May 20, 2010.

Modification of Affiliation Rules for Interest Expense Allocation Purposes

The annual interest expense of certain affiliated corporations must be allocated to each affiliate in the group. Under current Treasury regulations, an affiliated group for purposes of allocating interest expense includes domestic corporations and certain foreign corporations that have a substantial amount of income that is effectively connected with a U.S. trade or business. Under the bill, this definition of an affiliated group would be expanded to include each foreign corporation where (i) at least 80% of either the vote or value of the stock of the foreign corporation is owned directly or indirectly by another member of the affiliated group and (ii) more than 50% of the gross income of the foreign corporation is effectively connected with the conduct of a U.S. trade or business. This provision would be effective for taxable years that begin after the bill is enacted.

Repeal of the "80/20" Rules

Under current law, interest paid by a U.S. corporation that, during an applicable period, derives at least 80% of its gross income from foreign sources in an active business conducted offshore (an "80/20 Corporation") is foreign source, and therefore not subject to U.S. withholding tax. In addition, dividends paid by an 80/20 Corporation are exempt from U.S. withholding tax to the extent attributable to foreign source income, although the dividend remains U.S. source. The bill would repeal these 80/20 rules for taxable years beginning after December 31, 2010 (subject to certain grandfathering provisions).

Source Rule for Guarantee Fees

The treatment of guarantee fees under the source rules has been unclear. The IRS has long taken the position that amounts received with respect to guarantees are to be sourced by analogy to the source rule for interest, i.e., by reference to the residence of the payor. The Tax Court recently rejected the IRS's position, however, and held that guarantee fees are sourced by analogy to the source rule for services, *i.e.*, by reference to the location in which the guarantee "services" are performed. *See Container Corp.*, 134 T.C. No. 5 (2010). Thus, under the *Container Corp*. holding, guarantee fees paid by a U.S. subsidiary to its foreign parent would not be subject to U.S. withholding tax. The bill responds to this case by codifying the IRS's position and adding a new source rule for amounts received with respect to guarantees. Under the rule, a guarantee fee will be U.S. source if it is paid either (a) by a noncorporate resident or a U.S. corporation, or (b) by a foreign person if the guarantee fee is connected with income that is, or is treated as, effectively connected with the foreign person's conduct of a U.S. trade or business. Accordingly, amounts received by a non-U.S. person with respect to such guarantees would be U.S. source. The press release accompanying the bill indicates that this change will result in outbound guarantee fees being subject to U.S. withholding tax at a rate of 30% (or such lower rate as specified under an applicable treaty), although by its terms, the bill does not speak to whether a guarantee fee is "fixed or determinable annual or periodical gains, profits or income." The new source rule would apply only to guarantees issued after the date of the bill's enactment and therefore would not affect the treatment under the source rules of existing guarantees, including those addressed in *Container Corp*. If the bill is enacted, it is unclear whether other fees, such as commercial letter of credit fees, might be treated as U.S. source by analogy to guarantee fees.

Leveraged Spin-offs

The bill would limit a distributing corporation's ability, in an otherwise tax-free spin-off, to distribute securities or nonqualified preferred stock of the controlled corporation to creditors of the distributing corporation. Under current law, in a divisive D reorganization, liabilities assumed by the controlled corporation and money transferred from the controlled corporation to creditors of the distributing corporation are taxable to the distributing corporation to the extent in excess of the tax basis of the assets contributed to the controlled corporation. These rules, however, allow the tax-free transfer of securities and nonqualified preferred stock in the controlled corporation to the distributing corporation's creditors

without regard to tax basis. The bill would amend section 361 to extend the basis limitation to a transfer of controlled securities or controlled nonqualified preferred stock to the distributing corporation's creditors. This provision would apply to exchanges occurring after the date of the bill's enactment, with certain exceptions.

Repeal of Boot-Within-Gain Limitation

The bill includes a provision to repeal the so-called "boot-within-gain" limitation of section 356(a). Under current law, if the receipt of boot in a reorganization has the effect of a dividend, the transferring shareholder's dividend inclusion is capped by the gain realized in the exchange. The bill repeals this limitation for any reorganization—whether domestic or cross-border—in which the exchange has the effect of a dividend, requiring instead that the property be treated as a dividend to the extent of the distributing corporation's earnings and profits. In the case of an acquisitive D reorganization, the bill would further amend section 356 to provide that the earnings and profits of each corporation that is a party to the reorganization would be taken into account in determining the amount of the dividend under rules similar to section 304. Treasury would have the authority to issue regulations extending this earnings and profits rule to other types of reorganizations. The provision would apply to all exchanges occurring after the date of enactment, with certain exceptions.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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