



# United States tightens rules on foreign tax credits and other international tax provisions

On August 10, provisions tightening US foreign tax credit and other international tax rules became law. This briefing summarizes key provisions that: deny foreign tax credit benefits produced by treating share acquisitions as asset acquisitions for US tax purposes; limit foreign tax credits arising from controlled foreign corporations' investments in US property; and deny foreign tax credits for foreign tax on income that the person claiming the credit has not yet recognized for US tax purposes.

This briefing provides only general information, not advice on which you can rely to avoid US tax penalties.

On August 10, 2010, President Obama signed the Education Jobs and Medicaid Assistance Act of 2010 (HR 1586) into law. The Act gives temporary additional funding to states and school districts to prevent lay-offs of teachers and other public employees and to support healthcare and social services programs. The cost of these temporary measures is offset by permanent revenue raisers, styled as provisions to "close tax loopholes," primarily related to claims for foreign tax credits by US taxpayers. As part of an ongoing quest for revenue, the Act has further complicated an already extremely complex area of US federal income tax law.

This briefing summarizes certain key tax provisions of the Act, which:

- deny foreign tax credit benefits produced by treating the acquisition of a foreign company's shares as an acquisition of its assets, which creates a permanent difference between the company's taxable income as calculated for foreign and US tax purposes;
- limit the amount of foreign tax credits available for certain investments by controlled foreign corporations (CFCs)<sup>1</sup> in US property;
- prevent splitting foreign tax credits from the income to which they relate by denying foreign tax credits for foreign tax on income that the person claiming the credit has not yet recognized for US tax purposes;
- repeal special rules applicable to so-called 80/20 companies; and

- modify rules applicable to certain cross-chain sales between non-US companies in foreign-based groups.

## Provisions limiting foreign tax credits available to US taxpayers

### Limitation on amount of foreign tax credit related to investment by CFC in US property

If a CFC invests in US property, which includes making loans to US affiliates or guaranteeing loans by US affiliates, its direct US shareholders are required to include a deemed dividend in their US federal gross income (a "section 956 inclusion") and are entitled to a foreign tax credit with respect to the section 956 inclusion for foreign taxes of the CFC they are deemed to have paid.

Under prior law, the amount of foreign taxes a US shareholder was deemed to have paid was determined based on the pools of earnings and foreign taxes paid of only the CFC making the investment in US property, even if that CFC was held through a chain of other foreign corporations.<sup>2</sup> Congress and the Obama Administration believed that prior law allowed domestic corporations to segregate high-taxed and low-taxed foreign earnings in separate CFCs in the same chain of ownership and to selectively trigger section 956 inclusions as a means of repatriating high-taxed foreign earnings without additional US tax or with excess foreign tax credits to offset US tax

<sup>1</sup> A CFC is a foreign corporation in which one or more US shareholders directly, indirectly or constructively owns more than 50 percent by vote or value. A US shareholder for this purpose is any US person that owns, directly, indirectly or constructively, 10 percent or more of the voting stock of a foreign corporation.

<sup>2</sup> For CFCs, a deemed paid foreign tax credit is allowed with respect to six tiers of corporations.

on other foreign source income that bore foreign tax at less than the US tax rate.

For acquisitions of US property by a CFC after December 31, 2010, the Act limits the foreign tax credit available to a domestic corporation to the amount to which it would have been entitled if cash equal to the amount of the section 956 inclusion had been distributed up through the foreign corporations between the CFC investing in US property and the domestic corporation. For this purpose, foreign withholding taxes that would have been imposed on such distributions are ignored. Thus, if one or more foreign corporations above the CFC has a pool of low-taxed earnings, the foreign tax credit available with respect to the section 956 inclusion is reduced to a “blended” tax rate. The provision therefore has the effect of reducing the deemed paid tax credit available for section 956 inclusions attributable to CFCs with high-taxed earnings if they are held through a chain of foreign corporations with lower-taxed earnings.

#### **Denial of foreign tax credits for transactions resulting in permanent difference between US and non-US taxable income**

Certain transactions treated for non-US tax purposes as share acquisitions are treated as asset acquisitions under US federal income tax law, including where a US purchaser makes a section 338(g) election when acquiring a non-US subsidiary or a “check-the-box” election is made to disregard a non-US target before acquisition by a US purchaser. As a result, the non-US target’s assets have a cost basis for US federal income tax purposes, while their bases remain unchanged for foreign tax purposes. A similar phenomenon occurs in the case of partnerships that have in effect a section 754 election, pursuant to which the partnership’s asset basis with respect to a transferee partner is adjusted to approximate the effect of a purchase by the transferee partner of its share of the partnership’s assets. The foregoing transactions, and similar transactions to be identified by the Treasury in regulations, are referred to as “covered asset acquisitions.” Typically, these transactions result in increased depreciation or amortization deductions for US federal income tax purposes.

The Act denies a foreign tax credit for the “disqualified portion” of non-US income taxes paid or accrued after

a covered asset acquisition. The disqualified portion for any taxable years equals the ratio of the aggregate basis differences (which are generally determined based on US federal income tax principles and cannot be less than zero) allocable to that year for all relevant foreign assets to the income on which the foreign tax in question is computed. An asset is a “relevant foreign asset” only if income, deduction, gain or loss from the asset is taken into account in determining the foreign income tax and can include goodwill, going concern value and other intangible assets. Basis differences are allocated to taxable years using the applicable cost recovery method for US federal income tax purposes. Special rules apply on a disposal of an asset before its cost has been fully recovered. Thus, the Act will limit a US purchaser’s ability to benefit both from higher cost recovery deductions for US federal income tax purposes and larger foreign tax credits attributable to higher foreign taxes resulting from lower cost recovery deductions for non-US tax purposes.

This provision generally applies to covered asset acquisitions after December 31, 2010. Exceptions apply if a transaction between unrelated parties is:

- made under a written agreement that is binding on January 1, 2011 and remains binding thereafter;
- described in a ruling request submitted to the US Internal Revenue Service on or before July 29, 2010; or
- described on or before January 1, 2011 in a public announcement or filing with the US Securities and Exchange Commission.

#### **Rules to prevent splitting foreign tax credits from the income to which they relate**

To limit arbitrage and other transactions seen as abusive by Congress and the Obama Administration, the Act seeks to prevent US taxpayers from claiming foreign tax credits without taking into account the foreign income to which the underlying foreign taxes relate. For this purpose, the Act introduces a matching rule that suspends direct foreign tax credits until the taxable year in which the taxpayer takes into account the income to which the foreign tax credit relates. A “deemed paid” foreign tax credit is suspended until the related income is taken into account for US federal tax purposes by the foreign corporation or a domestic corporation entitled to claim

a deemed paid credit. In the case of a partnership, the matching rule is applied at the partner level.

Suspension of the foreign tax credit is triggered by a “foreign tax credit splitting event,” which occurs if the income (as determined for US federal income tax purposes) to which a foreign income tax relates is taken into account by a “covered person.” Covered persons include: entities in which the foreign taxpayer owns directly or indirectly at least 10 percent by vote or value; persons that own directly or indirectly at least 10 percent by vote or value in the foreign taxpayer; persons that are related in specified ways to the foreign taxpayer; and other persons to be specified in future Treasury regulations. A foreign tax credit splitting event does not occur where the same entity pays or accrues foreign income tax and takes into account the related income but does so in different taxable periods due to differences between US and non-US timing rules. Treasury regulations may address the application of this new matching rule to hybrid financial instruments. Legislative history further indicates that regulations also may treat unrelated counterparties in certain sale-and-repurchase transactions and other transactions deemed abusive as covered persons.

The new provision will apply to foreign income taxes paid or accrued by US taxpayers in taxable years beginning after December 31, 2010. When applying the deemed paid tax credit to periods after December 31, 2010, the new provision applies to foreign taxes paid or accrued by foreign corporations before that date.

### **Separate foreign tax credit limitation basket for income re-sourced under treaties**

Certain income tax treaties to which the United States is a party contain provisions that treat income that would be US source under US domestic law as foreign source. The Act provides that, with respect to US taxpayers electing the benefits of such a treaty, income re-sourced under the treaty falls within a separate income basket when applying the foreign tax credit limitation, so that foreign taxes paid on such income cannot reduce US tax on other types of foreign income.

### **Modification of rules for allocating interest expense**

To determine the amount of foreign source income when computing the foreign tax credit limitation, a taxpayer must allocate and apportion deductions between US and foreign source income according to complex rules. For allocating interest expense, all members of an affiliated group generally are treated as a single corporation and interest is allocated based on asset basis rather than gross income. Under Treasury regulations, certain foreign corporations already were treated as members of an affiliated group for these purposes but, depending on the extent of their US activities, only a portion of their assets and interest expense was taken into account.

In an effort to prevent tax planning aimed at increasing a US group’s foreign tax credit limitation, the Act expands the extent to which the assets and interest expense of foreign corporations that conduct business in the United States and are owned by members of a US affiliated group are taken into account in allocating and apportioning the interest expense of the affiliated group. This provision applies to taxable years beginning after the date of enactment.

### **Certain other provisions affecting foreign activities and investments**

#### **Repeal of special rules for 80/20 companies**

Interest and dividends paid by domestic corporations generally are treated as income from US sources and are thus subject to US federal withholding tax unless an exemption (such as the portfolio interest exemption or a treaty exemption) applies. Under prior law, all or a portion of interest and dividends paid by a domestic corporation that satisfied an 80 percent active foreign business requirement (a so-called “80/20 company”) was treated as foreign source income and thus was not subject to US federal withholding tax. Companies that did not generally earn as much as 80 percent of their income from active foreign business could take advantage of this rule simply by concentrating dividends from their active foreign subsidiaries into one year. This exemption particularly benefitted non-US shareholders and lenders subject to basic 30 percent withholding because their home country has no tax treaty with the United States, they did

not qualify for treaty benefits or the portfolio interest exemption was not available.

The Act repeals this sourcing rule effective for taxable years beginning after December 31, 2010. A special grandfathering rule applies to a limited class of domestic corporations that satisfy the 80 percent active foreign business requirement under prior law in their last taxable year beginning before January 1, 2011, that satisfy a stricter 80 percent active foreign business requirement going forward and that do not add a substantial line of business after the date the repeal is enacted. Under another grandfathering provision, interest payable to an unrelated person by an 80/20 company on an obligation outstanding on the date of enactment of the repeal continues to be treated as foreign source, absent a significant modification of the obligation, which is treated as the deemed issuance of a new obligation.

#### **Certain deemed redemptions by foreign subsidiaries**

If a corporation buys stock of a related corporation in exchange for property, the transaction generally is characterized for US federal income tax purposes as a redemption and typically results in a dividend to the seller in the amount of the property, to the extent first of the acquiring corporation's and then the target corporation's earnings and profits (E&P). To the extent the dividend is from the acquiring corporation's E&P, the seller is deemed to have received a dividend directly from the acquirer.

Under prior law, if a CFC that was part of a foreign-based group acquired stock of a domestic affiliate from a foreign affiliate that itself was not a CFC, this rule could be used to extract non-previously taxed E&P of the acquiring CFC by a direct dividend to the foreign seller, without an intermediate distribution to a domestic corporation that would have been subject to US federal income tax in its hands and potentially subject to withholding tax on a subsequent distribution to a foreign recipient.

The Act limits the amount of a foreign acquirer's E&P that is taken into account in determining the amount of the deemed dividend to prevent extractions of E&P that circumvent the US tax net. Under the Act, E&P of the acquiring CFC is not deemed distributed unless at least 50 percent of the deemed dividend arising from

the acquisition (determined without regard to the new provision) would be subject to US federal income tax in the year the dividend arises or be includible in the E&P of a CFC. If the new rule applies, none of the foreign acquiring corporation's E&P is taken into account and the deemed dividend is limited to the E&P of the target corporation. Thus, the acquiring CFC's E&P can be taxed to its US shareholders at a later date.

The new provision applies to acquisitions occurring after the date of enactment.

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