CCH Tax Briefing

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Education/Jobs/Medicaid Assistance Act of 2010

August 11, 2010

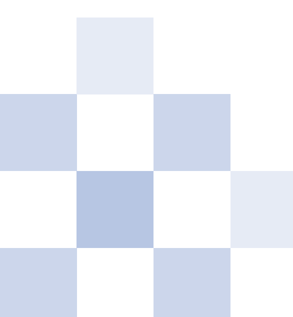
Special Report

HIGHLIGHTS

- Eliminates Foreign Tax Credit Splitting
- Reduces Foreign Tax Credits On Stepped-Up Assets
- Restricts Treaty Use To Resource U.S. Income
- Limits Use Of Sec. 956 On Deemed Dividends
- Repeals 80/20 Rules; Reinstates Withholding
- Ends Advance Earned Income Credit

INSIDE

Foreign Tax Credit Reforms 1
Repeal of 80/20 Rules 3
Redemptions by Foreign Subsidiaries 3
HIRE Act Foreign Account Disclosures 3
Removal of Advance EIC 3



President Signs Foreign Tax Reforms Into Law; Helps Fund Education/Medicaid Relief

Returning briefly from its summer recess, the House on August 10 approved, by a 247 to 161 vote, a critical education and Medicaid funding bill, H.R. 1586, which includes a $9 billion package of international tax reforms. Wasting no time, President Obama signed the bill into law that same afternoon, on August 10, 2010, as Pub. Law 111-226. The Senate had approved the legislation earlier on August 5 by a 61 to 39 margin.

Riding the coattails of a popular measure to fund the jobs of well over 100,000 teachers and first responders, as well as help states fund Medicaid shortfalls, the international tax provisions provide the bulk of the bill's revenue offsets needed under Congressional "pay-go" rules. The bill also adds another $1.1 billion in revenue by eliminating the advance payment option for the earned income credit (EIC).

TIMELINE. House leaders called members back from their August recess to approve the bill before the school year began and an estimated 140,000 teachers otherwise would have lost their jobs. The President signed the bill the same day on which it passed the House, making August 10, 2010 the official "date of enactment."

IMPACT. Both the Obama administration and Congress have been particularly concerned about U.S. multinational corporations that reduce their U.S. taxes by shifting income abroad to affiliates in low-tax jurisdictions. According to the administration, some companies have been manipulating the rules on transfer pricing, tax deferral, the foreign tax credit and other provisions to avoid U.S. taxes. The bill incorporates a host of international tax reform measures, primarily focused on foreign tax credit abuses.

None of the foreign tax provisions come as a surprise, although their inclusion in the education/Medicaid funding bill was unexpected. Some of the foreign tax reform measures first appeared in the administration's fiscal year 2011 budget; others were developed by Congress and already appeared in several other tax bills this year, including the stalled extenders bill approved in the House on May 28 and, most recently, by a House majority on July 31. The repeal of the advance EIC also appeared in other bills, including the Senate's pending Small Business Jobs Bill.

FOREIGN TAX CREDIT REFORMS

The foreign tax credit is intended to prevent double taxation of foreign income earned by U.S. multinational corporations. The foreign tax credit is generally limited to a taxpayer's U.S. tax liability on its foreign-source taxable income; it is not supposed to offset U.S. taxes on U.S.-source income. However, according to the Obama administration, corporations have been using devices that avoid U.S. tax on foreign income and apply the foreign taxes to offset U.S. tax due on other income. Corporations have also permanently avoided U.S. taxes by reinvesting the foreign source income offshore.

Splitting Foreign Tax Credits

The new law adopts a matching rule proposed by the Obama administration to prevent the separation of creditable foreign taxes from the associated foreign income. The new law suspends the recognition of foreign tax credits until the related foreign income is taken into account for U.S. tax purposes.

IMPACT. This reform aims to prevent inappropriate separation of creditable foreign taxes, since the separation does not relieve double taxation. In addition, the foreign tax credit should not be used to reduce the foreign corporation's earnings and profits. The new rules also apply to partnerships and S corporations. The provision does not affect timing disparities from normal tax accounting differences between U.S. and foreign tax rules.

IMPACT. The rules will apply to foreign income taxes paid or accrued in tax years beginning after December 31, 2010. The change is estimated to raise $4.25 billion over 10 years.

The provision also includes special rules for Section 902 corporations (that is, a foreign corporation in which a domestic corporation owns at least 10 percent of the voting stock).

Covered Asset Acquisitions

If an acquisition of corporate stock is treated as an asset acquisition, such as through a Code Sec. 338(g) election, the assets acquired obtain a stepped-up basis. This also occurs when a taxpayer obtains an entity that is treated as a corporation for foreign tax purposes but as a partnership, disregarded entity, or other noncorporate entity for U.S. purposes. These hybrid arrangements for covered asset acquisitions, however, typically result in a step-up in basis in the assets of the acquired entity to fair market value only for U.S. taxes, not foreign taxes. As a result, there are more foreign tax credits than are needed to prevent double taxation.

The new law prevents taxpayers from claiming the foreign tax credit on foreign income that is never taxed in the U.S. under this scenario. The rules apply to transactions occurring after December 31, 2010. Transition rules exempt any covered asset acquisition between unrelated parties under a contract binding on January 1, 2011 and at all times thereafter.

Treaties and Foreign Source Income

The foreign tax credit is limited to the maximum U.S. tax rate (35 percent) that could apply to foreign-source income of a U.S. taxpayer. According to the Obama administration, some taxpayers use treaties to artificially inflate foreign-source income, such as dividends and interest, beyond what is needed to avoid double taxation, by shifting the source of certain assets (for example, U.S. securities) to foreign branches and disregarded entities. The treaty then categorizes the income as foreign source, increasing the taxpayer's foreign-source income and allowing the use of foreign tax credits beyond the maximum U.S. tax that could apply. The new law respects the treaty provisions but segregates the income so that it is not used for claiming foreign tax credits. The provision applies a separate foreign tax credit limitation to each item that would ordinarily be U.S.-sourced but that the taxpayer treats as foreign source under a treaty.

> "The new law incorporates a host of international tax reform measures, primarily focused on foreign tax credit abuses."

IMPACT. The new law conforms the foreign tax credit treatment of taxpayers operating abroad through foreign branches and disregarded entities to the treatment of those using foreign corporations. The rules apply to tax years beginning after the date of enactment.

Section 956 Rule

Code Sec. 956 (containing the controlled foreign corporation or "CFC" rules) is designed to restrict or eliminate tax-deferral for certain categories of passive or highly mobile income. It includes an anti-abuse rule (also called the "hopscotch" rule) that recharacterizes income from the sale of property as a direct payment of a dividend from a foreign subsidiary to its U.S. shareholder, effectively deeming the dividend to "hopscotch" over intermediary tax-haven based subsidiaries in a multi-tier chain of companies. This anti-abuse rule ironically created what is considered a loophole of its own. By taking advantage of the "hopscotch rule, the foreign tax credit on the deemed dividend can be greater than the foreign tax credit would be on an actual dividend.

The new law limits the use of Code Sec. 956 for tax credit planning by limiting the foreign tax credits claimed on a deemed dividend under Code Sec. 956 to the amount that would have been allowed on an actual dividend.

IMPACT. The new law applies to U.S. property acquired by a CFC after December 31, 2010.

Interest Expenses

Taxpayers use various techniques to minimize foreign-source interest expense, artificially boosting foreign-source income and providing more foreign tax credits than would otherwise accrue. Existing Treasury regulations aim to prevent taxpayers from excluding foreign interest expense from the foreign tax credit limitation by placing the expense in foreign subsidiaries, according to the Obama administration. The new law modifies the affiliation rules and strengthens the anti-abuse rules by treating the foreign corporation as a member of an affiliated group when allocating and apportioning interest.

IMPACT. The new law will ensure that all the foreign corporation's assets and foreign-source interest expense are taken into account when allocating and apportioning the interest expense

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of the affiliated group and determining the foreign tax credit limitation. The provision applies to tax years beginning after the date of enactment.

REPEAL OF 80/20 RULES

Dividends and interest paid by a U.S. corporation to a foreign person are generally considered U.S.-source income to the recipient, subject to withholding of up to 30 percent. The dividends and interest may be excluded from U.S. withholding if at least 80 percent of the U.S. corporation's gross income is foreign- source during a three-year test period and is attributable to the active conduct of a foreign trade or business (a so-called "80/20" company). Further, interest received from an 80/20 company can increase foreign source income and the foreign tax credit for a U.S. multinational company.

The new law repeals the 80/20 company rules for interest and dividends paid by a domestic corporation that meets the 80/20 test, and for interest paid by resident alien individuals who meet the 80/20 test.

IMPACT. The new law imposes withholding on dividends paid by a U.S. corporation and repeals the rule that would treat the interest as foreign source. The provision includes a transition rule and a grandfather rule. The general repeal applies to tax years beginning after December 31, 2010.

REDEMPTIONS BY FOREIGN SUBSIDIARIES

If a foreign parent company owns a U.S. company, which in turn owns a foreign subsidiary, the foreign subsidiary's earnings are taxed in the U.S. when distributed to the U.S. shareholder. When the U.S. company distributes the earnings to its foreign parent, a 30 percent withholding tax applies. Companies have devised a technique to avoid U.S. taxation of the foreign subsidiary's earnings. The foreign parent sells stock in the U.S. company to its foreign subsidiary and then recharacterizes the gain as a dividend paid directly to the foreign subsidiary. This is referred to as "hopscotching" in this context because the dividend bypasses any intermediary shareholders. This had allowed the foreign subsidiary's earnings to completely and permanently bypass U.S. taxes.

The new law requires the subsidiary's earnings to remain subject to U.S. tax when repatriated to the foreign parent as a dividend.

IMPACT. The new law eliminates the use of hopscotching by preventing the reduction in the foreign subsidiary's earnings. The new rule aims to prevent the foreign subsidiary's earnings and profits from permanently escaping U.S. taxation. This provision applies immediately to acquisitions after the date of enactment.

HIRE ACT FOREIGN ACCOUNT DISCLOSURES

The Hiring Incentives to Restore Employment (HIRE) Act included a package of foreign account disclosure, reporting and compliance rules. The new law clarifies when the limitations period will be tolled for corporations failing to provide certain information on cross-border transactions or foreign assets. If failure to provide the required information is due to reasonable cause and not willful neglect, the three-year statute of limitations period will not be tolled. If the taxpayer establishes reasonable cause, the limitations period is suspended only for the item or items related to the failure to disclose.

IMPACT. The change is a technical correction and is not estimated to have any revenue effect. The provision applies to returns filed after March 18, 2010, the date of enactment of the HIRE Act, and to any other return for which the assessment period had not yet expired on that date.

ADVANCE EARNED INCOME CREDIT

The advance earned income credit (EIC) allows qualified individuals to receive part of the credit in each paycheck during the year the taxpayer expects to qualify for the credit. As an additional revenue offset, the new law eliminates the advance EIC effective for tax years beginning after December 31, 2010.

IMPACT. Elimination of the advance EIC is projected to impact a relatively small number of taxpayers. According to the Senate Finance Committee, only about three percent of eligible EIC recipients elect to take the advance EITC, despite IRS outreach to increase participation. The Obama administration recommended elimination of the advance EIC, citing existing non-compliance issues, in addition to administrative cost savings to both employers and the IRS from its removal.

H.R. 1586 REVENUE PROVISIONS OVER 10 YEARS*

Provision	Revenue
Splitting Foreign Tax Credits	$4.250 billion
Covered Asset Acquisitions	$3.645 billion
Advance EIC	$1.131 billion
Section 956	$704 million
Interest Expenses	$390 million
Treaties and Foreign Source Income	$250 million
Redemptions by Foreign Subsidiaries	$250 million
80/20 Rules	$153 million

*Sources: Joint Committee on Taxation and Congressional Budget Office

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