

**Congress Passes Sweeping International Tax Reform**

The American Jobs Creation Act of 2004 (the “Act”) became law on October 22<sup>nd</sup>. While the Act was originally intended simply to repeal the extraterritorial income exclusion regime,<sup>1</sup> it in fact contains a dizzying array of domestic and international tax provisions. Some of the more significant international tax provisions are summarized below.<sup>2</sup>

**Elective Temporary Dividends Received Deduction for Foreign Earnings**

Perhaps the most significant international tax provision is the elective, temporary dividends received deduction (“DRD”) for foreign earnings, provided by new Code Section 965. Under new Code Section 965:

- The DRD is equal to 85 percent of the dividends received from CFCs;<sup>3</sup>
- The DRD is available only for “cash” dividends, and so it is not available for amounts includible in income under Code Sections 78, 367, or 1248. In the case of a Code Section 332 liquidation to which Code Section 367(b) applies, the DRD is only available if the shareholder receives cash as part of the liquidation;<sup>4</sup>
- In general, the amount of a dividend that is eligible for this benefit is limited to the greater of \$500,000,000 or the amount shown in the “applicable financial statement” as earnings permanently reinvested outside the U.S.;<sup>5</sup>
- Dividends are deductible only to the extent they are extraordinary, *i.e.*, in excess of the annual average for the “base period years;”<sup>6</sup>
- The dividend cannot be financed with related party debt;<sup>7</sup> and
- The dividend must be invested pursuant to a “domestic reinvestment plan” which:
  - is approved by the company’s president, CEO or comparable officer and is subsequently approved by the company’s board of directors, management committee, executive committee or similar body; and
  - provides for reinvestment of the dividend in the U.S. (other than as payment for executive compensation), including the funding of worker hiring and training, infrastructure, R&D, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation.<sup>8</sup>

A taxpayer may elect the benefits of new Code Section 965 for either (i) the taxpayer’s taxable year that began before October 22<sup>nd</sup> or (ii) the taxpayer’s first taxable year beginning after October 22<sup>nd</sup>, but not both.<sup>9</sup>

*If you have any questions, regarding these new U.S. international tax rules, please contact:*

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**New Code Section 965 provides an unprecedented opportunity to repatriate no-taxed or low-taxed earnings at a very low effective U.S. tax rate. As with all tax planning, the devil will be in the details – what earnings to repatriate, when to repatriate (the taxable year that began before October 22<sup>nd</sup>, or the taxable year beginning after October 22<sup>nd</sup>), and how to repatriate (e.g., a Code Section 301 distribution versus a Code Section 304 transfer).<sup>10</sup>**

### **Reduction in Number of Foreign Tax Credit Baskets**

For taxable years beginning after December 31, 2006, the number of foreign tax credit baskets will be reduced from nine to two: a passive basket (e.g., dividends, interest, rents, royalties) and a general basket for all nonpassive income. While the reduction in the number of foreign tax credit baskets holds the promise of greater simplicity, it will likely take years for taxpayers to work through the various pools of pre-December 31, 2005 earnings and profits (look-thru 10/50 pools, non-look-thru 10/50 pools, etc.).

### **Reduction of FTC Carryback Period; Extension of FTC Carryover Period**

The Act shortens the 2 year carryback to 1 year and extends the 5 year carryforward period to 10 years for excess foreign taxes. Excess foreign taxes arising in taxable years beginning after October 22<sup>nd</sup> are subject to the new 1 year carryback period. Excess foreign taxes arising after October 22<sup>nd</sup> are subject to the new 10 year carryforward period.

**A significant planning opportunity exists with respect to excess foreign taxes that are generated after October 22<sup>nd</sup> and before the first taxable year beginning after October 22<sup>nd</sup>. As noted above, foreign taxes arising in taxable years beginning after October 22<sup>nd</sup> are subject to the new 1 year carryback period while excess foreign taxes arising after October 22<sup>nd</sup> are subject to the new 10 year carryforward period. As such, for a calendar year taxpayer, any excess foreign taxes that arise between October 22, 2004 and December 31, 2004, can be carried back 2 years (under the old rule) or carried forward 10 years (under the new rule).**

### **Alternative Minimum Tax Foreign Tax Credit**

The alternative minimum tax limitation on the credit for foreign taxes (credit permitted only against 90 percent of a taxpayer's tentative minimum tax) has been repealed for taxable years beginning after December 31, 2004.

### **Recapture of Overall Foreign Loss on Sale of CFC**

Under Code section 904(f)(3), certain dispositions of assets used in a foreign trade or business will cause a 100 percent recapture of a taxpayer's overall foreign loss or "OFL." The Act expands this unfavorable rule. Effective as of October 22<sup>nd</sup>, under new Code Section 904(f)(3)(D), a disposition of shares of a CFC will also be considered a disposition for this purpose and will also cause a 100 percent OFL recapture.

**While certain nonrecognition transactions are excepted by this new provision (e.g., Code Sections 351 and 721 transfers), importantly Code Section 361 transactions (tax-free asset reorganizations) are not. As such, taxpayers can inadvertently trigger a 100 percent OFL recapture with the very common transaction wherein F1 is dropped below F2 followed by a check-the-box election to treat F1 as a disregarded entity for U.S. federal tax purposes.<sup>11</sup>**

### **Recharacterization of an "Overall Domestic Loss"**

For taxable years beginning after December 31, 2006, if a taxpayer sustains an "overall domestic loss," a portion of the taxpayer's U.S. source income will be re-sourced as foreign source income in subsequent years.<sup>12</sup> For this purpose, the term "overall domestic loss" means a domestic loss to the extent such loss offsets foreign-source taxable income for the taxable year or for any preceding taxable year by reason of a carryback.<sup>13</sup>

### **Modification of the Interest Expense Allocation Rules**

The Act allows taxpayers, for taxable years beginning after December 31, 2008, a one-time election to change their method of allocating and apportioning interest expense to foreign-source income.<sup>14</sup> If elected, interest paid by domestic members of the "worldwide affiliated group" is allocated and apportioned to foreign-source income in an amount equal to the excess (if any) of (i) the unrelated party interest expense of the worldwide affiliated group multiplied by the ratio of foreign assets of the worldwide affiliated group to total assets of the worldwide affiliated group, over (ii) the interest expense of all foreign corporations which are members of the worldwide affiliated group.<sup>15</sup>

**While this election should have the beneficial effect of apportioning less interest expense to foreign-source income for most taxpayers, the election is not available until 2009.**

### **Sourcing of Interest Paid by Foreign Partnerships**

New Code Section 861(a)(1)(C) provides that interest paid by a foreign partnership, where the partnership is predominantly engaged in the active conduct of a trade or business outside the U.S. and where the interest is not allocable to income which is effectively connected with a U.S. trade or business, will be treated as foreign-source interest income. This provision is effective for taxable years beginning after December 31, 2004.

**This new provision raises the question as to whether dividends paid by a foreign corporation to a foreign partnership (in the context of leveraged foreign partnership structures) count in determining whether such foreign partnership is predominantly engaged in the active conduct of a trade or business outside of the U.S. Insofar as this provision is meant to bring the sourcing of interest paid by a partnership in line with the sourcing of interest paid by a corporation, it is likely that such dividends would count because they count in determining whether a domestic corporation meets the 80 percent foreign business requirement of Code Section 861(c).**

### **Attribution of Stock Ownership Through Partnerships – Deemed Paid Credits**

New Code Section 902(c)(7) provides, for purposes of Code Sections 902 and 960, that stock owned, directly or indirectly, by or for a partnership (domestic or foreign) is considered actually owned proportionately by the partners of the partnership. This provision applies to taxes of foreign corporations for taxable years beginning after October 22<sup>nd</sup>.

**This amendment mercifully dispels the nagging uncertainty created by Rev. Rul. 71-141 that the IRS would not allow the attribution of stock ownership through a non-U.S. partnership for Code Section 902 purposes and thus deny any deemed paid foreign taxes that might pass through such non-U.S. partnership.**

### **Look-thru Treatment for Sales of Partnership Interests**

The Act amends Code Section 954(c) to provide that a sale by a CFC of a partnership interest, in which the CFC owns a 25 percent or greater interest, will be treated as a sale of its proportionate interest in the underlying assets of such partnership for purposes of subpart F. This amendment applies to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

**For taxpayers that have continuing uneasiness about the Dover-style "check and sell" transaction, new Code Section 954(c)(4) presents a wonderful planning opportunity: instead of making an election to treat a lower-tier CFC as a disregarded entity before the sale, bring in a new shareholder and make an election to treat the lower-tier CFC as a partnership before the sale (assuming that the partnership can stay in existence after the sale).**

### **Clarification of Banking Business for Determining Investments in U.S. Property**

The Act overturns the taxpayer-friendly decision in The Limited by amending Code Section 956(c)(2) and narrowing the definition of a "bank." As such, credit card companies will no longer be treated as "banks" for purposes of Code section 956. This amendment is effective as of October 22<sup>nd</sup>.

### **Study of Earnings Stripping Provisions**

The Act directs the Secretary of the Treasury to conduct a study regarding the effectiveness of the earnings stripping provisions of Code Section 163(j), specifically:

- The effectiveness of Code Section 163(j) in preventing the shifting of income outside of the U.S.;
- Whether deficiencies of such provisions place U.S.-based businesses at a competitive disadvantage relative to foreign-based businesses;
- The impact of the earnings stripping activities on the U.S. tax base;
- Whether laws of foreign countries facilitate earnings stripping out of the U.S.; and
- Whether changes to the earnings stripping rules would affect jobs in the U.S.

The Secretary is to submit such report (including specific recommendations as to how to improve the earnings stripping provisions) to Congress no later than June 30, 2005.

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*Because sound legal advice must necessarily take into account all relevant facts and developments in the law, the information you will find in this Advisory is not intended to constitute legal advice or a legal opinion as to any particular matter.*

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<sup>1</sup> Subject to certain transition and grandfathering rules, the Act completely repeals the extraterritorial income exclusion for transactions entered into after December 31, 2006. In its place, new Code Section 199 provides for a special deduction for those engaged in manufacturing.

<sup>2</sup> Other interesting international tax provisions, though not summarized here, include: (i) clarification that amounts includible in income under Code Section 367(d) [relating to outbound transfers of intangibles] are to be treated as royalties and, as such, will be subject to the look-thru provisions of Code Section 904(d)(3); (ii) repeal of the foreign personal holding company and foreign investment company regimes; (iii) various provisions relating to inversions and expatriations; and (iv) new penalties for failure to report interests in foreign financial accounts.

<sup>3</sup> Code Section 965(a)(1).

<sup>4</sup> Code Section 965(a)(1) and (c)(3).

<sup>5</sup> Code Section 965(b)(1). Code Section 965(c)(1) provides that the term "applicable financial statement" means the most recently audited financial statement (including notes and other documents which accompany such statement) which is certified on or before June 30, 2003 as being prepared in accordance with generally accepted accounting principles and which is used for purposes of a statement or report (i) to creditors, (ii) to shareholders or (iii) for any other substantial nontax purpose. In the case of a corporation required to file a financial statement with the SEC, the term "applicable financial statement" means the most recent statement filed with the SEC on or before June 30, 2003.

<sup>6</sup> Code Section 965(b)(2). The "base period years" are the three taxable years of the five most recent taxable years ending on or before June 30, 2003, which are determined by disregarding the taxable year with the largest amount

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of dividends from CFCs and the taxable year with the smallest amount of dividends from CFCs. See Code Section 965(c)(2).

<sup>7</sup> Code Section 965(b)(3).

<sup>8</sup> Code Section 965(b)(4).

<sup>9</sup> Code Section 965(d).

<sup>10</sup> At IFA's "International Tax Seminar" held in Boston on November 18<sup>th</sup>, John Merrick (Special Counsel to Associate Chief Counsel (International)) indicated that a Notice, and then a Revenue Ruling, should be forthcoming in the near term which provide additional guidance regarding new Code Section 965 (*e.g.*, permissible reinvestment plans). Additionally, a proposed technical corrections bill will clarify certain aspects of new Code Section 965 (*e.g.*, that Code Section 78 will not apply to any foreign taxes not allowed as a credit under new Code Section 965).

<sup>11</sup> See Rev. Ruls. 67-202 and 67-274, which hold that a Code Section 351 transfer or Code Section 368(a)(1)(B) reorganization followed by a Code Section 332 liquidation is treated as an asset reorganization for U.S. federal income tax purposes.

<sup>12</sup> Code Section 904(g)(1).

<sup>13</sup> Code Section 904(g)(2).

<sup>14</sup> Code Section 864(f)(6).

<sup>15</sup> Code Section 864(f)(1)(B). For this purpose, the term "worldwide affiliated group" means the group of companies consisting of (i) the includible members of the affiliated group (as defined in Code Section 1504(a), determined without regard to Code Section 1504(b)(2) [relating to insurance companies] and (4) [relating to Code Section 936 corporations]) and (ii) all CFCs in which such members, in the aggregate, meet the ownership requirements of Code Section 1504(a)(2) (80-percent of vote and value) either directly or indirectly. Code Section 864(f)(1)(C).