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Legislative summary of extenders legislation unveiled with significant international revenue raisers

Legislative Summary of The American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213

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Senate Finance Committee Chairman Max Baucus (D-Mont.) and House Ways and Means Committee Chairman Sander Levin (D-Mich.), May 20, 2010, released a 28-page legislative summary of the *American Jobs and Closing Tax Loopholes Act of 2010,* that will be paid for with $14.5 billion of international tax reform. While the formal legislative text is expected to be issued shortly, at the time of publication, this article was drafted on the basis of the information provided in the legislative summary.

The international extenders covered in the legislation include:

... Code Sec. 954(c)(6) , known as the look-through rule for related controlled foreign corporations (CFCs), that generally excludes from U.S. federal income tax certain dividends, interest, rents, and royalties received or accrued by one CFC of a U.S. multinational enterprise from a related CFC that would otherwise be taxable under subpart F. The provision, originally enacted under the *Tax Increase Prevention and Reconciliation Act of 2005,* and extended under numerous subsequent bills, applied to the tax years of a foreign corporation beginning after December 31, 2005, and before December 31, 2010. H.R. 4213 proposes to extend the look-through rule for one year.
... Code Sec. 954(h) , or the active financing exception, that generally excludes from U.S. federal income tax qualified banking or financing income of an eligible CFC that would otherwise be taxable income pursuant to the subpart F regime. Code Sec. 954(h) was enacted by the *Tax and Trade Relief Extension Act of 1998,* and was effective for taxable years of foreign corporations beginning after December 31, 1997, and before January 1, 2010. H.R. 4213 proposes to extend the active financing exception for one year.
... Special rules applicable to regulated investment companies, that would extend for one year the tax treatment of interest-related dividends, short-term capital gain dividends, and other special rules applicable to foreign shareholders that invest in regulated investment companies.
... Extension of temporary increase in limit on cover over of rum excise tax revenues to Puerto Rico and the Virgin Islands.

International revenue raisers

H.R. 3213 contains significant provisions for international revenue raisers, which in the legislative summary was placed under the caption "Closing Foreign Tax Loopholes."

Douglas Stransky, a partner in the Boston offices of Sullivan & Worcester LLP, said that he didn't believe that the proposals would create more jobs and that characterizing the international provisions as "loopholes" was wrong.

Foreign tax credit income matching. H.R. 4213 imposes a matching rule that would disallow the separation of creditable foreign taxes from associated foreign income. The proposal, adopted from Treasury's *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals,* (Greenbook) would raise $6.325 billion over 10 years.

Foreign tax credit disallowed on foreign income not subject to U.S. tax in covered asset acquisition. The legislation would disallow the use of foreign tax credits to foreign income that is not subject to U.S. income tax because of a covered asset acquisition.

Separate application of foreign tax credit limits to items resourced under tax treaties. The legislation also attempts to address a perceived abuse where taxpayers use the U.S. treaty network to artificially increase their foreign-source income whereby income-producing assets (e.g. investments in U.S. securities) are transferred out of the U.S. to foreign branches and disregarded entities. Under the treaty, the income produced by the transferred assets is considered foreign-source income, which in turn increases the taxpayer's available foreign tax credits.

Limit on Code Sec. 956 for foreign tax planning. H.R. 4213 would limit the amount of foreign tax credits that may be claimed with respect to an Code Sec. 956 deemed dividend. The summary provides an example whereby a foreign subsidiary with a high tax expense distributes a dividend up through a chain of companies, and notes that the foreign tax credit received on the dividend is a blend of the tax rates of each foreign subsidiary in the chain. "If there is a tax haven company in that chain, the U.S. tax due on the dividend may be significantly higher than the tax would have been if the foreign subsidiary's dividend could have simply 'hopscotched' over the chain as a direct distribution to the U.S. shareholder," the legislative summary says.

If the goal of international tax reform is to bring jobs back to the U.S., Stransky said he didn't believe this proposal will encourage many multinationals to repatriate money back to the U.S.

To illustrate his point, Stransky considered the same facts as the example, but that the subsidiary directly below the U.S. shareholder maintained an earnings and profits deficit. "When that foreign subsidiary receives the dividend from its subsidiary, it's not enough to offset the deficit," he said. "When the subsidiary pays a dividend to the U.S. shareholder, no foreign tax credits are allowed because the denominator is "zero," because of the deficit."

"One way to avoid that problem is the affirmative use of 956, which has nothing to do with the problem described in the proposal, but is a practical solution to a real issue for many multinationals," he said. While Stransky conceded that there might not be any residual U.S. tax on the money because it came from a high tax subsidiary, at least the money will come back to the U.S.

Redemptions by foreign subsidiaries. The legislation would also address provisions that allow foreign multinationals to avoid paying taxes on the earnings of their foreign corporations owned through U.S. companies. The summary provides an example whereby a foreign parent company owns a U.S. company, which in turn owns a foreign company. The foreign parent sells its stock in the U.S. company to its foreign subsidiary and the cash received is treated as a dividend from the foreign subsidiary, but the foreign subsidiary's earnings bypass U.S. taxation. The bill would eliminate this type of tax planning.

Modification of affiliation rules for allocating interest expenses. The drafters of the legislation also sought to address techniques that minimize a taxpayer's foreign source interest expense that results in increased foreign source income that subsequently generates excess foreign tax credits. The summary provides that foreign source interest expenses will be taken into account in determining the foreign tax credit limitation.

Source rules for guarantee fees. In addressing an adverse decision in *Container Corp.* the government appears to have responded by providing that guarantees issued after the bill's enactment date would be sourced like interest and would be subject to U.S. withholding (when paid by a U.S. person to a foreign person). Under *Container Corp.* any fee paid to the U.S. parent would be U.S.-source income, unless resourced under a treaty.

Noting that most U.S. multinationals guarantee the debt of their foreign subsidiaries, Stransky said he was happy to see this proposal included in the legislative summary.

"If there was a withholding tax on the payment, imposed by the foreign jurisdiction, there could have been a potential problem with the ability to credit that tax since the income associated therewith would have been U.S. source," Stransky said. "This proposal clarifies that it will be foreign source, which is beneficial to U.S. multinationals."

Repeal of the 80/20 rules. The bill also seeks to repeal the 80/20 company rules because the administration's Greenbook (for FY 2011) suggests that the provision is subject to perceived abuses. Under current law, interest received from an 80/20 company (i.e. a U.S. corporation that receives 80% or more of its gross income for the testing period from an active foreign business) is foreign sourced income and no more than 20% of a dividend received by foreign shareholders may be subject to a 30% withholding tax.

Correction to the SOL provision in the HIRE Act. Finally, the legislation would clarify the circumstances under which the statute of limitations will be tolled for companies that fail to provide required information on their cross-border transactions.

The House is expected to review the bill on May 21, 2010 while the Senate will begin considering the legislation next week.

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