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by Marie Sapirie and Kristen A. Parillo

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The revenue offset provisions in an unnamed education jobs and state fiscal relief bill (H.R. 1586, P.L. 111-226), signed into law on August 10, represent fundamental changes in some long-standing U.S. international tax rules that will require significant guidance from the Treasury Department.

The new rules limit the use of the foreign tax credit, create a special rule for some redemptions by foreign subsidiaries, tighten the affiliation rules, repeal the 80/20 regime, and make a technical correction to section 6501(c)(8). The provisions were included in the tax extenders package that the Senate abandoned in June. (Two proposals found in the extenders legislation, relating to guarantee fees and the boot-within-gain rule, were not included in P.L. 111-226.) Some of the new rules had been proposed in prior legislation or budget plans, but others were brand new when they appeared in the extenders legislation introduced in May. (For the bill as passed, see *Doc 2010-17927* or *2010 TNT 155-27*.)

Practitioners who have appeared in recent webcasts, and others who have spoken with Tax Analysts, say the new laws present several open issues, particularly because the legislation delegates authority to Treasury and the IRS to issue guidance in some areas.

Practitioners also say the enactment of the provisions leaves an open question as to how Congress will deal with the revenue shortfall in the extenders bill that may be considered this fall.

''They may need to identify new revenue-raising provisions to make that bill revenue neutral,'' Barbara M. Angus, a partner with Ernst & Young LLP's international tax services, said during an August 12 E&Y webcast.

On a KPMG LLP webcast on August 17, Ron Dabrowski, a principal in KPMG Washington National Tax's international corporate services group, called the bill a ''sign of the times'' in that the enrolled bill had no official title, yet this ''no-name legislation seems to be ushering in international tax reform.'' He noted that for the past 10 or 12 years, ''changes to the international rules have been basically taxpayer-favorable and aimed at reducing complexity,'' but the latest reform ''has effectively repealed a number of rules that have been around for 20, 30, 40 years,'' a change that has ''definitely added complexity.''

Matching Rules in Section 909

As initially outlined in proposed regulations in 2006 and more recently in both Treasury's fiscal 2011 green book and the tax extenders legislation this past May, FTCs must now be matched to the income to which they relate under new section 909. The new section provides that taxpayers may not receive an FTC for foreign income taxes paid until they also take into account the income subject to the foreign tax. Section 902 corporations that have an FTC splitting event may not take the foreign income tax into account until the year in which the related income is taken into account, the tax is not added to the corporation's foreign tax pool, and its earnings and profits are not reduced by the tax.

David G. Noren, a partner at McDermott Will & Emery LLP, told Tax Analysts there is a pressing need for guidance on the provision because it takes a brand-new, much broader approach than the one taken in the 2006 proposed regulations. ''Whereas it would have been difficult for an unwary taxpayer to stumble into the proposed regulations, the new statutory provision could apply to a range of everyday transactions in the absence of clarifying guidance,'' he said.

Anna Voortman of the international tax services group at E&Y noted during the E&Y webcast that the significant question under new section 909 is, ''What is a foreign tax credit splitting event?'' The statute defines a splitting event as occurring when one person pays a foreign income tax but the related income is (or will be) taken into account by another person who is a covered person.

''Section 909 seems to embrace the technical taxpayer rules and acknowledges that under U.S. tax law,

the income earner and the taxpayer can be different entities within a group,'' Voortman said.

Robert Wilkerson, a principal in KPMG Washington National Tax's international corporate services group, explained during the KPMG webcast that the original proposed regulations ''generally attempted to change the technical taxpayer and push taxes down or over to associate them with the income that gave rise to the tax, but section 909 does not attempt to change the technical taxpayer rule.'' He added that ''in many cases, it will lead to the same answer as you would get under the proposed regulations,'' but in some cases, the section 909 approach ''will preserve creditability in cases where the proposed regulations would have denied creditability; for example, individual owners of a foreign reverse hybrid.''

Jeffrey Michalak, Americas director of international tax services at E&Y, identified the definition of related income as another area ripe for guidance. He said the U.K. group relief scenario ''really starts to open up all kinds of scary possibilities about what related income might be and what types of transactions in the ordinary course of business might inadvertently be caught by something like a broad definition of related income.'' Wilkerson said that the definition of related income is ''somewhat circular,'' but that the Joint Committee on Taxation explanation makes it clear that ''related income is determined under U.S. tax principles, not foreign tax principles.'' (For JCX-46-10, see *Doc 2010-17846* or *2010 TNT 154-16*.)

Congress left it to Treasury to determine in regulations what exceptions might be appropriate, as well as to address the treatment of hybrid instruments under section 909. Wilkerson said the JCT explanation ''makes it clear that hybrid instruments would be caught by this legislation,'' but he said it also ''raises the question whether other hybrid-type transactions might also be potentially subject to the splitter rules.''

According to the JCT report, the law grants Treasury the authority to issue regulations that could include ''successor rules addressing circumstances such as where, with respect to a foreign tax credit splitting event, the person who pays or accrues the foreign income tax or any covered person is liquidated.'' The report also contemplates Treasury guidance on the treatment of losses, deficits in E&P, and timing differences between U.S. and foreign tax law.

Voortman added that how to take suspended taxes into account would also need to be addressed administratively. In particular, she said that two issues would be how taxpayers should release suspended taxes in a gross-up scenario when a portion of offshore pooled earnings is pulled up, and ''what happens to changes in our tax base, such as net operating losses, that occur in a year after the year in which a tax was accrued?'' The JCT report also suggests that regulations may provide guidance regarding group relief and disregarded payments. (For prior news analysis on group relief, see *Doc 2010-15622* or *2010 TNT 135-5*.)

The new matching rules are generally effective regarding foreign income taxes paid or accrued in taxable years beginning after December 31, 2010. For foreign income taxes paid or accrued by a section 902 corporation in taxable years beginning on or before December 31, 2010, the amendments are effective only for purposes of applying sections 902 and 960 to periods after that date.

Limitation on Deemed-Paid Taxes on Section 956 Inclusions

Section 960 has been amended to add a limitation on the amount of foreign taxes that a U.S. shareholder is deemed to pay regarding any section 956 inclusion to the amount that would have been allowed had an actual dividend been paid through the chain of ownership to the United States. ''What this provision does is add a separate computation which creates a ceiling limitation on the 902 foreign tax credit that will potentially be available to you with respect to a 956 inclusion,'' Michalak said.

The limit in section 960(c) requires a ''calculation of a notional amount of 902 credit that would be available if the inclusion entity paid an amount of cash equal to that inclusion up through the chain of ownership to the U.S. shareholder,'' said Michalak. If the notional amount (referred to as the ''hypothetical credit'' in the JCT explanation) is less than the foreign taxes deemed paid with respect to the U.S. shareholder's section 956 inclusion, the amount of foreign taxes deemed paid regarding the section 956 inclusion is limited to the hypothetical credit.

The objective of the limit is to override the hopscotch rule — which allows U.S. shareholders to calculate indirect credits as if the amount of the inclusion was paid directly from the inclusion entity to the U.S. shareholder, disregarding other entities in the chain of ownership — in cases where that rule ''gives a better answer than a passthrough provision would,'' said Michalak. He explained that the new limitation is ''a ceiling rule, meaning that it's kind of, 'Heads government wins, tails taxpayer loses.'''

Michalak also noted that the provision applies regardless of whether a taxpayer credits or deducts taxes. ''If you're in a deduction year, it's actually somewhat favorable,'' because ''to the extent that it reduces your 902 inclusion, it actually allows taxpayers in a noncreditable situation to defer the foreign taxes,'' he said.

The new provision applies to acquisitions of U.S. property that take place after December 31, 2010.

Covered Asset Acquisitions

Congress added new section 901(m) to partially deny an FTC in situations when a section 338, section

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754, or check-the-box election results in the creation of additional asset basis eligible for recovery for U.S. tax purposes without a corresponding increase in the basis of the assets for foreign tax purposes. The portion of the FTC denied is the ratio of the aggregate basis differences allocable to a particular taxable year with respect to all relevant foreign assets divided by the income on which the foreign income tax is determined.

''Effectively, what we do is to push the earnings and profits as computed under U.S. tax law back to the statutory rate under the laws of the jurisdiction in which the covered asset acquisition occurred,'' said Voortman. Dabrowski noted that although the credits are disallowed, they ''are deductible for E&P purposes,'' which he called ''somewhat of a consolation prize.''

Voortman also noted that several questions remain regarding the statutory language, including whether the computation is made on a transaction-by-transaction or cumulative basis, and, for situations where the target entity is a foreign holding company with various disregarded entities underneath, how many covered asset acquisitions have occurred. Voortman said that later disposals of the assets that were subject to the covered asset acquisition provisions could also be problematic in jurisdictions where exemptions are allowed for the disposal of certain assets, because in that situation, ''you will eliminate or reduce the creditability of your taxes at a ratio greater than would otherwise be expected as a result of these provisions.''

The legislation anticipates that Treasury will issue regulations identifying other similar transactions that result in a mismatch between the basis of assets for U.S. tax purposes and the basis for foreign tax purposes.

Joseph Calianno, international technical tax practice leader at Grant Thornton LLP, told Tax Analysts that the new provision will create complexity and administrative burdens for taxpayers in calculating their FTC. Dabrowski agreed that both the anti-FTC-splitting rule and covered asset acquisition provisions ''have a lot of complexity attached to them, and they are not raising a whole lot of revenue, so it's sort of a bad trade-off.''

The new rule applies generally to covered asset acquisitions that take place after December 31, 2010.

Items Resourced Under Treaties

A separate FTC limitation is applied to each item that is resourced under a treaty under revised section 904(d). Voortman explained that the provision ''prevents the cross-crediting of taxes associated with this resourced income.''

Angus said, ''This separate basket treatment really parallels the provision that has long been in the statute for separate basket treatment of dividends.''

The limitation on items resourced under treaties is effective for taxable years beginning after August 10, 2010.

Corporate Redemptions Under Section 304(b)(5)

Amended section 304(b)(5) targets a specific type of section 304 related-party stock sale transaction when there is a ''sandwich organizational structure,'' namely when a foreign corporation owns a U.S. corporation that, in turn, owns a controlled foreign corporation. The amended provision limits the E&P of the foreign acquiring corporation that is taken into account in determining the amount and source of dividends from the CFCs to the foreign parent. Voortman said the provision would make it costly to move future earnings through the U.S. corporation and up to the foreign acquirer.

Calianno said that prior to that modification to section 304(b)(5), a section 304 transaction could be used to reduce or eliminate the E&P of an acquiring CFC in a section 304 transaction when the CFC acquired a target corporation from a foreign corporation higher up in the organizational chain. The acquiring CFC's E&P could source a dividend under section 304(b)(2) to a non-CFC foreign corporation higher up in the organizational chain. Thus, the CFC's E&P could bypass potential U.S. corporate and withholding taxes that otherwise could result if the E&P were instead distributed in the form of a dividend from the CFC to its U.S. parent, and then from the U.S. parent to its parent (the non-CFC foreign corporation).

''The change made to section 304(b)(5) prevents this result, so taxpayers will now need to consider restructuring alternatives to alleviate some of the tax inefficiencies with a sandwich structure,'' Calianno said.

The change to section 304 is effective for acquisitions after August 10, 2010.

Repeal of 80/20 Rules

The amendment to section 861(a) ''essentially . . . repeals the current 80/20 regime completely,'' Michalak said during the E&Y webcast. That regime treated interest from domestic corporations that met an 80 percent active foreign business income test (80/20 companies) as foreign-source and exempted dividends paid by 80/20 companies from withholding. The new provision repeals the preferential treatment for interest and dividends paid by an 80/20 company on a prospective basis but leaves two grandfather rules for corporations that meet the 80/20 test for the last taxable year beginning before January 1, 2011.

The amendment applies to taxable years beginning after August 10, 2010.

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Modification of Interest Expense Allocation Rules

Section 864(e) was modified to provide that a foreign corporation is a member of an affiliated group and all of that foreign corporation's assets and interest expense are taken into account for purposes of allocating and apportioning interest expense if more than 50 percent of the foreign corporation's gross income is effectively connected income, and at least 80 percent of either the vote or value of all outstanding stock of the foreign corporation is owned by members of the affiliated group.

That was ''a statutory modification to correct what I think everyone would agree was a drafting error in a 22-year-old regulation under section 861 with respect to the definition of an expanded affiliated group,'' Michalak explained. The now-obsolete regulation ''tried to articulate a kind of partial group split-off,'' and that ''awkward language . . . really led to certain opportunities that have been eliminated here,'' Michalak said.

The new rule applies to taxable years beginning after August 10, 2010.

Technical Correction to Section 6501(c)(8)

P.L. 111-226 also added a reasonable cause exception to section 6501(c)(8), which suspends the statute of limitations on assessment of tax when a taxpayer has failed to file certain information returns on foreign transfers. That exception limits the suspension of the statute of limitations to the item or items related to the information that were not reported.

The technical correction was presumably made in response to practitioner outcry following an amendment made to section 6501(c)(8) as a result of the Hiring Incentives to Restore Employment Act (HIRE Act, P.L. 111-147) enacted in March. That amendment suspended the statute of limitations for an entire tax return that failed to include the required foreign information reporting forms, causing controversy among practitioners and the business community because of the adverse effect it might have on financial statements. (For prior coverage, see *Doc 2010-11157* or *2010 TNT 97-3*.)

Chester Abell, national tax director of tax accrual services at E&Y, said during the E&Y webcast that now that ''these reasonable cause provisions have been enacted, this gives a company an opportunity to consider whether or not its processes and controls that exist with respect to its compliance procedures do in fact meet the criteria for reasonable cause.'' He welcomed the change as ''really good news'' but noted that it does not answer all of the questions regarding what meets the reasonable cause standard.

Douglas S. Stransky, a partner with Sullivan & Worcester LLP in Boston, told Tax Analysts that the technical correction is helpful but said taxpayers who have reporting deficiencies will have to evaluate whether they have the ability to establish that those deficiencies were due to reasonable cause and not willful neglect. The JCT report provides that:

> In the absence of reasonable cause or the presence of willful neglect, the suspension of the limitations period and the subsequent three-year period that begins after information is ultimately supplied apply to all issues with respect to the income tax return. In cases in which a taxpayer establishes reasonable cause, the limitations period is suspended only for the item or items related to the failure to disclose.

Stransky said that in light of the new provision, taxpayers should assess their cross-border transactions to ensure that they have filed all required information reporting forms related to those transactions. Taxpayers who discover deficiencies in their information reporting and who submit delinquent or amended filings must be sure that those filings contain well-documented reasonable cause statements requesting relief under section 6501(c)(8) and the waiver of any other penalties that might apply, he said.

''From a financial statement perspective, it is unclear whether the auditor will require a reserve for any deficient information reporting in light of the technical correction,'' Stransky said. ''This is because the taxpayer is requesting reasonable cause relief from the IRS. Since the IRS does not generally advise taxpayers whether such relief has been granted in the case of delinquent returns, a taxpayer may not have any certainty from a financial statement perspective until the expiration of the statute of limitations. So, auditors may still require a reserve.''

The technical correction is applicable to returns filed after March 18, 2010, the date the HIRE Act was enacted.

Future Legislation

The enactment of the revenue offset provisions in the new law raises the question of what Congress will use as revenue raisers in the future. Given that Congress has used up several provisions that have been recycled in various legislative proposals, practitioners are wondering what revenue raisers may be coming down the pike, particularly if Congress considers the tax extenders legislation in the fall.

Angus said during the E&Y webcast that two possibilities are proposals related to the boot-within-gain rule and the sourcing of guarantee fees, both included in the May tax extenders legislation but not in H.R. 1586. Those proposals were estimated by the JCT in May to raise a combined total of more than $2.5 billion over 10 years. (For JCX-30-10, see *Doc 2010-11969* or *2010 TNT 104-63*.)

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The section 356 boot-within-gain limitation proposal is intended to prevent U.S. corporations from repatriating cash from foreign subsidiaries with minimal U.S. tax consequences and to prevent foreign corporations from repatriating cash from U.S. subsidiaries with minimal withholding. The provision would repeal the current boot-within-gain limitation for reorganizations if the exchange has the effect of a distribution of a dividend. Dabrowski said that ''in the international M&A context, that [possible repeal] was a big item issue'' in the May extenders bill. However, he noted that it appears unlikely that the proposal will be retroactive to May 20, the effective date in the extenders bill, even if it is enacted this fall, giving taxpayers a temporary reprieve.

The guarantee fee proposal would source guarantee fees in the United States if they were paid by domestic corporations or noncorporate residents. Payments by foreign persons would be U.S.-source to the extent that they are allocable to the effectively connected income of a U.S. trade or business. The measure would prospectively moot *Container Corp. v. Commissioner,* 134 T.C. No. 5 (Feb. 17, 2010), a Tax Court decision in which the court determined that guarantee fees should be sourced like services. (For the opinion, see *Doc 2010-3399* or *2010 TNT 32-9*.)

Speaking on a Deloitte LLP webcast on August 11, Mark Fidelman of Deloitte noted that the guarantee fee provision ''proposes that the change in sourcing would apply only to transactions taking place after the date of enactment,'' so ''the window is still open for foreign guarantors to avail themselves of the *Container Corp.* decision, at least until the date of enactment'' of the guarantee fee source rules. The deadline for appealing the decision has passed.

Calianno said that the guarantee fee and boot-within-gain proposals will likely be used as revenue raisers for the extenders legislation. He noted, however, that the guarantee fee proposal is also included in the Senate's Small Business Jobs Act of 2010, introduced in July and scheduled for a vote in the Senate on September 14. Calianno noted that Congress can include the same provision in more than one bill but must remove the measure if one of the bills gets enacted. (For prior coverage of the small-business bill, see *Doc 2010-17605* or *2010 TNT 152-2*.)

Calianno said other recent international tax proposals — such as the Obama budget proposals regarding offshore transfers of intangibles and subpart F, FTC pooling, and deferral of deductions for interest expense — might be too controversial to include in a tax extenders package.

Noren said Congress's use of the May extenders bill's revenue raisers in P.L. 111-226 was not helpful for the eventual enactment of an extenders bill. ''There really are no uncontroversial international revenue raisers,'' he said. ''In terms of getting the extenders bill through, Congress would lose the business community's support if the bill has significant revenue raisers for transfer pricing and subpart F.''

Noren said the guarantee fee proposal may be relatively noncontroversial among U.S.-based multinational companies but that the boot-within-gain proposal may be somewhat more controversial. Another Obama budget proposal that would limit deductions for some reinsurance premiums paid to foreign reinsurance firms is a narrow, sector-specific measure, but one that is extremely controversial within the affected sector, he said. Rep. Richard E. Neal, D-Mass., chair of the House Ways and Means Select Revenue Measures Subcommittee, has proposed a similar, but broader, measure in H.R. 3424. (For H.R. 3424, see *Doc 2009-18189* or *2009 TNT 154-28*. For prior coverage, see *Doc 2010-15699* or *2010 TNT 135-3*.) ◆

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