Client Alert.

August 11, 2010

Tax Legislation Affecting Foreign Transactions Enacted Into Law

By Stephen L. Feldman, Joy S. MacIntyre, and Remmelt A. Reigersman

On August 10, 2010, President Obama signed into law the Education Jobs and Medicaid Assistance Act of 2010 (the "Bill"). The Bill includes several U.S. federal income tax provisions affecting foreign transactions which are primarily aimed at limiting the use of foreign tax credits by U.S. taxpayers. In addition, the Bill repeals the rules regarding "80/20 companies," as further described below.

RULES TO PREVENT SPLITTING FOREIGN TAX CREDITS

The Bill contains a provision designed to prevent a U.S. taxpayer from claiming a credit for foreign taxes imposed on income prior to the time the taxpayer takes the foreign income into account in computing its U.S. taxes. In the case of a "foreign tax credit splitting event," the Bill limits the ability to claim a foreign tax credit to the year in which the taxpayer takes the foreign income into account in computing its U.S. taxes. A "foreign tax credit splitting event" occurs when one person pays the foreign income tax and a related person (including through a 10% ownership interest, by vote or value) takes the associated income into account for U.S. federal income tax purposes. In the case of foreign taxes paid by a foreign subsidiary of a U.S. corporation, similar rules apply for purposes of determining indirect foreign tax credits and earnings and profits. This provision of the Bill is generally effective with respect to foreign taxes paid or accrued after December 31, 2010 and gives the Treasury broad authority to issue new regulations, including regulations that treat an unrelated counterparty as a related person in certain sale-repurchase transactions and certain other transactions deemed abusive.

COVERED ASSET ACQUISITIONS

In the case of certain "covered asset acquisitions" with respect to foreign entities, the Bill denies a credit for a "disqualified portion" of the foreign taxes paid by the entity. In a "covered asset acquisition," a basis step-up in the assets of the foreign entity is generally achieved for U.S. federal income tax purposes but not for foreign tax purposes because the transaction is treated as an acquisition of the assets of the foreign entity for U.S. federal income tax purposes, but is treated as an acquisition of the entity for foreign tax purposes. Through increased depreciation or amortization deductions, the stepped-up basis in assets results in lower earnings for U.S. tax purposes than for foreign tax purposes. Upon a subsequent distribution of earnings, the U.S. taxpayer generally may take into account a relatively large foreign tax credit while including a relatively small dividend. The Bill denies a credit for a "disqualified portion" of the foreign taxes.

A transaction is defined as a "covered asset acquisition" if it is (a) a stock purchase for which a Section 338[1] election has been made; (b) treated as an asset acquisition for U.S. federal income tax purposes but as a stock acquisition (or disregarded) for foreign tax purposes; (c) an acquisition of an interest in a partnership that has a Section 754 election in

[1] Section references are to the Internal Revenue Code of 1986, as amended.

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effect; or (d) a similar transaction as provided by the Treasury. The Joint Committee on Taxation's technical explanation of the Bill indicates that "covered asset acquisitions" may include, among other things, a purchase of interests in a hybrid entity by a U.S. person or its foreign subsidiary, and certain deemed liquidations of foreign subsidiaries that result from the making of a U.S. entity classification election. Prior to enactment of the Bill, such transactions were recognized as perfectly legitimate and acceptable tax planning techniques.

Under the Bill, the "disqualified portion" of the foreign tax credits is a ratio equal to (i) the aggregate basis step-up allocable to the taxable year (using the applicable cost recovery method) over (ii) the income on which the foreign income tax is determined. The Bill gives the Treasury authority to issue regulations, including provisions to exempt certain covered asset acquisitions from this limitation. This provision of the Bill applies to covered asset acquisitions after December 31, 2010 subject to a grandfather. Pursuant to the grandfather provision, the Bill does not apply to a covered asset acquisition between unrelated parties that is (i) entered into pursuant to a written agreement which was binding on January 1, 2011 and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before July 29, 2010, or (iii) described on or before January 1, 2011 in a public announcement or in a filing with the Securities and Exchange Commission.

ITEMS RESOURCED UNDER TREATIES

If, under certain U.S. tax treaties, the right to tax a particular type of income is allocated to the foreign country treaty partner, the treaty provisions will generally "resource" that income as foreign source if the income would otherwise be treated as U.S. source under U.S. internal law. As a result of such treaty provisions, a U.S. taxpayer may increase its foreign tax credit limitation because it has increased its foreign source income. In response, the Bill provides that the foreign tax credit limitation (which generally limits the allowable foreign tax credit to a taxpayer's U.S. tax liability on its foreign-source taxable income) will be applied separately with respect to each item that is resourced under a treaty. This allocation provision applies to taxable years beginning after August 10, 2010.

LIMITATION ON FOREIGN TAXES DEEMED PAID WITH RESPECT TO SECTION 956 INCLUSIONS

If a U.S. corporation owns a chain of foreign corporations and a lower tier entity makes an investment in certain "U.S. property," the U.S. corporation is treated, pursuant to Section 956, as if it has received a dividend directly from the lower tier entity. For foreign tax credit purposes, the U.S. corporation is treated as if it has paid a portion of the lower tier entity's foreign taxes. This can result in a benefit to the U.S. corporation in calculating its foreign tax credit if the lower tier entity is located in a higher tax jurisdiction than the intermediate entities in the ownership chain. The Bill limits the foreign tax credit in such a transaction to an amount of foreign tax that the U.S. corporation would have been deemed to have paid if the Section 956 inclusion had been an actual cash distribution made up the ownership chain to the U.S. corporation. This provision is effective for transactions entered into after December 31, 2010.

CERTAIN REDEMPTIONS BY FOREIGN SUBSIDIARIES

Under Section 304, a corporation's purchase of stock of a related corporation may be recharacterized as a distribution instead of a sale for U.S. federal income tax purposes. As a result of this deemed distribution, a foreign parent corporation that owns another foreign corporation through an intermediate U.S. corporation, may avoid a U.S. dividend withholding tax by selling stock in the intermediate U.S. corporation to its indirect foreign subsidiary. This potential avoidance results from Section 304 treating the transaction as a deemed distribution, first, out of the earnings and profits of the indirect foreign subsidiary and, thereafter, out of the earnings and profits of the intermediate U.S. corporation. To

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the extent that the distribution is considered to come from the earnings and profits of the indirect foreign subsidiary, rather than from the earnings and profits of the intermediate U.S. corporation, it is treated as paid directly by the indirect foreign subsidiary and is not subject to U.S. withholding tax. The Bill provides that if more than 50% of the amount of the deemed dividend would not be (i) subject to U.S. tax for the taxable year in which the deemed dividend arises, or (ii) includible in the earnings and profits of a "controlled foreign corporation," then no amount of the deemed distribution is considered out of the earnings and profits of the indirect foreign subsidiary. As a result, the deemed distribution would be considered out of the earnings and profits of the intermediate U.S. corporation and would therefore give rise to a dividend subject to U.S. withholding tax. This provision applies to transactions entered into after August 10, 2010.

MODIFICATION OF INTEREST EXPENSE ALLOCATION

In determining a taxpayer's foreign tax credit limitation, interest expense is allocated to each affiliate in a group, including domestic corporations and, in certain limited circumstances, foreign corporations. For purposes of the interest expense allocation rules, the Bill treats a foreign corporation as an affiliate of a group if more than 50% of its income is effectively connected with a U.S. trade or business and if it is at least 80% owned (by vote or value) by the affiliated group. As a result, a larger portion of any interest expense may be allocated to foreign subsidiaries thereby reducing foreign source income and limiting the use of foreign tax credits. This provision applies to taxable years that begin after August 10, 2010.

REPEAL OF "80/20" RULES

Under the law as it existed prior to enactment of the Bill, if a U.S. corporation, during a three-year testing period, derived at least 80% of its gross income from foreign sources and such income was attributable to the active conduct of a trade or business in a foreign country (generally referred to as an "80/20 company"), then interest paid by such corporation was treated as foreign source and therefore was not subject to U.S. withholding tax. Further, dividends paid by an 80/20 company were exempt from U.S. withholding tax to the extent attributable to foreign source income. These dividends, however, remained U.S. source income to the recipient. Subject to certain grandfathering clauses, the Bill repeals the 80/20 rules effective for taxable years beginning after December 31, 2010.

Under the grandfather clauses, if a U.S. corporation (i) meets the above-described 80/20 test for its taxable year beginning before January 1, 2011, (ii) meets a new modified 80/20 test with respect to each taxable year beginning after December 31, 2010, and (iii) has not added a substantial line of business after August 10, 2010, then any payment of dividend or interest will be exempt from U.S. withholding tax to the extent of its active foreign business income. Dividend and interest payments, however, are treated as U.S. source. In addition, under the grandfather clauses, the repeal of the 80/20 company provisions does not apply to the payment of interest to unrelated persons on obligations issued before August 10, 2010. A significant modification of an outstanding obligation, however, is treated as the issuance of a new obligation.

Contact:

Stephen L. Feldman
(212) 336-8470
sfeldman@mofo.com

Joy S. MacIntyre
(415) 268-6270
jmacintyre@mofo.com

Remmelt A. Reigersman
(212) 336-4259
rreigersman@mofo.com

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