Recently Enacted Provisions Relating to the Foreign Tax Credit

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Several new foreign tax credit provisions were signed into law on August 10, 2010, and take effect in 2011. Significant new rules include the anti-splitting provision of section 909, the basis difference rule of section 901 (m), the section 956 deemed paid credits rule of section 960(c), and the treaty re-sourced basket rule in section 904(d)(6). Each of these is briefly discussed below.

A. Anti-Splitting Rule

Under new section 909, foreign tax credits are essentially deferred (technically, foreign income taxes are not taken into account) until the taxpayer takes the related income into account for U.S. tax purposes, if there is a foreign tax credit splitting event. In the case of a tax paid or accrued by a section 902 corporation, foreign taxes are not taken into account for purposes of section 902 or 960 until either the section 902 corporation or a domestic corporation meeting the requirements of section 902(a) or (b) with respect the 902 corporation takes the related income into account under chapter 1 of the Code, if there is a foreign tax credit splitting event. A foreign tax credit splitting event occurs with respect to a foreign income tax if a covered person takes, or will take, the related income into account. Section 909(d)(1). A covered person is defined as a person related to the taxpayer by at least 10% direct or indirect ownership, a person related to the taxpayer under the standards of section 267(b) or 707(b), or any other person described by the Treasury. Section 909(d)(4).

"Related income," unfortunately, is not usefully defined in the statute, and is described merely as the income to which the foreign tax relates. Section 909(d)(3). Identifying related income with respect to any particular foreign income tax is likely to be one of the bigger challenges for taxpayers and the IRS in applying section 909. It will be necessary to identify related income in order to apply the new rule, because a foreign tax credit splitting event exists only if a related person takes such income into account for U.S. purposes, and foreign tax credits are then unavailable until the taxpayer takes the related income into account for U.S. purposes.

Related income will be determined under U.S. tax principles rather than according to foreign tax rules. An example in the Joint Committee's Technical Explanation of section 909 illustrates that related income may be income in the hands of a different person, and income of a different type, than foreign tax law perceives.[1] Treasury officials have also strongly implied that section 909 may apply to U.K. loss sharing fact patterns, in which a U.K. entity surrenders its loss to a related entity for U.K. tax purposes.[2]

Section 909 applies to foreign taxes paid or accrued in taxable years beginning after December 31, 2010. It also applies, for purposes of applying sections 902 and 960 to periods after such date, to foreign taxes deemed paid or accrued under section 902(a) or 960 in taxable years beginning after such date, even if such taxes were paid or accrued before 2011 (except that it will not apply to such pre-2011 taxes for purposes of determining earnings and profits under section 964(a)). In other words, for taxable years beginning after 2010, section 909 applies to the foreign tax pools of section 902 corporations and CFCS, even with respect to foreign taxes paid or accrued in earlier years. Section 909 could thus have a significant effect on multinationals' anticipated foreign tax credits.

An IRS official has predicted that guidance on section 909 will be issued by December 2010, and has invited taxpayers and practitioners to comment on which specific issues should be prioritized as the subject of the earliest-issued guidance.[3]

B. Foreign Taxes Attributable to Basis Differences

Newly enacted section 901(m) addresses situations in which an increased basis that is created for U.S. but not foreign tax purposes yields a permanent difference in the amount of U.S.-perceived and foreign-law-perceived taxable income, due to higher depreciation deductions and lower gain for U.S. tax purposes. The new rule provides that in the case of a covered asset acquisition, the disqualified portion of any foreign income tax with respect to income or gain attributable to the relevant assets is not taken into account under sections 901(a), 902, or 960.

A "covered asset acquisition" includes any of the following: 1) a qualified stock purchase under section 338(d)(3) to which a section 338(a) election applies, 2) a transaction treated as an asset acquisition under U.S. law and as a stock acquisition (or disregarded) by foreign law, 3) acquisition of a partnership interest if a section 754 election is in effect, or 4) "to the extent provided by the Secretary, any other similar transaction." Section 901(m)(2). The disqualified portion with respect to any covered asset acquisition is the ratio (expressed as a percentage) of the aggregate basis differences allocable to the taxable year for all relevant foreign assets, divided by the income on which the foreign income tax is determined. Section 901(m)(3). If the taxpayer fails to adequately substantiate such income, it may be determined by dividing the foreign tax by the highest applicable tax rate of the foreign country.

The income in the denominator of the disqualified portion fraction is the foreign tax base as determined under foreign law[4], but the basis difference in the numerator is determined under U.S. tax principles. The basis difference, for any relevant asset, is the excess of the adjusted basis immediately after the covered asset acquisition over the adjusted basis immediately before such acquisition. Negative basis differences are also taken into account. Basis differences are allocated among years "using the applicable cost recovery method." Section 901(m)(3)(B). If a relevant asset is disposed of, its remaining unused basis difference is taken into account for the disposition year. A "relevant foreign asset" means any asset (including intangibles) with respect to a covered asset acquisition if income, gain, deduction, or loss attributable to the asset is taken into account in determining the foreign income tax.

Unlike section 909, section 901(m) denies rather than deferring foreign tax credits. However, foreign taxes that are not creditable by reason of section 901(m) may be deductible, despite a taxpayer's election to claim credits for foreign taxes for the year. Section 901(m)(6). Allowance of such deductions may indicate that Congress understood that section 901(m) might apply to some non-abusive transactions. Congress also granted regulatory authority to the Treasury, including the authority to exempt "certain covered asset acquisitions" and relevant foreign assets with de minimis basis differences.

Section 901(m) applies to covered asset acquisitions after December 31, 2010. However, it contains a grandfather rule for any covered asset acquisition between unrelated persons that is pursuant to a written agreement binding on January 1, 2011 and thereafter, described in a ruling request submitted before July 30, 2010, or described on or before January 1, 2011 in a public announcement or an SEC filing.

C. Deemed Paid Foreign Taxes Associated with Section 956 Inclusions

New section 960(c) of the Code provides that the amount of foreign taxes deemed paid by a domestic corporation by reason of a section 951(a)(1)(B) inclusion (a section 956 inclusion relating to investments in U.S. property) attributable to earnings and profits of a foreign corporation that is a member of a qualified group (under section 902(b)) of such domestic corporation shall not exceed the amount of foreign taxes that would have been deemed paid by the domestic corporation if the amount of the inclusion had been distributed in cash from the foreign corporation up the chain of ownership to the domestic corporation. The amount of the hypothetical deemed paid credit is determined without regard to foreign taxes that would have been imposed on a cash distribution. Section 960(c)(1). Section 960(c) also grants the Treasury authority to issue guidance, including guidance to "prevent the inappropriate use of the foreign corporation's foreign income taxes not deemed paid by reason of" that provision. Section 960(c)(2). The new provision applies to acquisitions of United States property (within the meaning of section 956(c)) after December 31, 2010.

D. Separate Basketing for Treaty-Re-Sourced Income

The newly enacted provisions also include section 904(d)(6), which resembles section 904(h)(10) except that its application is not limited to U.S.-owned foreign corporations. Section 904(d)(6) provides that if an item would be treated as U.S.-source except for a treaty provision that provides foreign source treatment, and the taxpayer elects to apply the treaty rule to treat the item as foreign-source, sections 904(a), (b), and (c), and sections 902, 907, and 960 apply separately to that item. In other words, there is separate "basketing" for each item. "Item" is not defined in the statute, but the Treasury is granted authority to issue guidance on aggregating "related items of income." Section 904(d)(6)(C). Section 904(d)(6) applies to taxable years beginning after August 10, 2010 (i.e. taxable years beginning after date of enactment). It does not apply to any income item to which section 904(h)(10) or section 865(h) applies.

E. Other New Foreign Tax Credit Provisions

The newly enacted provisions also include a repeal of the 80/20 rule of section 861(a)(1)(A), with a grandfather rule for certain corporations meeting the 80 percent foreign business requirement for the last taxable year beginning before 2011. A modification of the affiliated group rule for purposes of allocating interest expense (see section 864(e)(5)(A)) is also among the new Code rules.

FOOTNOTES:

1. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representations on August 10, 2010, JCX-46-10 ("JCT Explanation").

2. See comments by Jose Murillo, reported in Sheppard, News Analysis: Your Advanced Course in Pending Foreign Tax Credit Tighteners, 2010 TNT 140-2, July 22, 2010; remarks of Manal Corwin, ABA Tax Section Joint Meeting, Joint International Developments Panel, September 24, 2010.

3. See comments of Barbara Felker at DC Bar Tax Section lunch, September 15, 2010.

4. See JCT Explanation, supra note 1.

Please let us know if we can be of any assistance with any foreign tax credit issues. To discuss such issues, you may contact any of our international tax attorneys listed below.

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