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Structuring International Operations Following 2010 Legislation

by

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1. Introduction

Like the weather in Washington, D.C., the provisions of U.S. tax law applicable to international operations changed often and dramatically in 2010. These changes reflected two major concerns of Congress. The first was concern over sophisticated tax planning techniques, sometimes referred to as "financial engineering," that maximized tax benefits beyond levels deemed appropriate by Congress. These plans often combined provisions generally thought to apply in the domestic tax context with foreign tax credits generated by operations of subsidiaries abroad. The result was to increase the benefit of foreign tax credits in a way that was viewed to be inconsistent with income measurement for U.S. tax purposes, yielding inflated foreign tax credits. The second was a belief that the level of tax compliance by U.S. taxpayers, other than publicly traded corporations, engaging in cross border financial transactions was low. The basic information reporting obligations imposed on financial institutions under U.S. domestic law stopped at the border. In the view of Congress, this contributed to tax evasion and new approaches were needed to protect the revenue.

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This paper addresses the principal provisions enacted into law in 2010. The new provisions are attributable to four new laws: the Hiring Incentives to Restore Employment Act,[3] the Education Jobs and Medicaid Assistance Act of 2010,[4] the Small Business Jobs Act of 2010[5] and the Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010.[6] The paper places the new provisions into context and explains how they will be applied.

2. Information Reporting And Related Withholding –FATCA

a. Context

Prior to the enactment of the HIRE Act, the U.S. withholding tax regime provided exclusively for a 30% withholding tax on items of U.S. source fixed and determinable annual and periodic income paid to non U.S. persons.[7] Withholding tax could be reduced by the presentation of a Form W-8BEN that contained a U.S. taxpayer identification number. The W-8BEN certified that the foreign recipient was the beneficial owner of the income and that the recipient was not a conduit or a fiscally transparent entity for U.S. income tax purposes. There is no withholding on gross proceeds – sales proceeds – paid to foreign persons other than in the context of a F.I.R.P.T.A. transaction[8] or a sale of intangible property for a contingent amount that is based on the productivity, use, or disposition of the property[9] and no withholding on payments to U.S. persons, except to the extent "domestic back-up withholding

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[3] Pub. L. 111-147 (signed 3/18/10). Subtitle A of Title V, the relevant part of the HIRE Act, is entitled "Foreign Account Tax Compliance" and is commonly referred to as "FATCA", an acronym derived from the original stand-alone bill. The legislation will be referred to herein in textual references as either "FATCA" or the "HIRE Act" and for citation purposes as "Pub. L. 111-147."

[4] Pub. L. 111-226 (signed 8/10/10)(the "Education Jobs and Medicaid Assistance Act" or "Pub. L. 111-226")."

[5] Pub. L. 111-240 (signed 9/16/10)(the "Small Business Jobs Act" or "Pub. L. 111-240").

[6] Pub. L. 111-312 (signed 12/17/10)(the "Tax Relief, Unemployment Reauthorization and Job Creation Act" or "Pub. L. 111-312.")

[7] Sections 1441 and 1442.

[8] Sections 897 and 1445 implement provisions enacted as part of the Foreign Investment in Real Property Tax Act of 1980, Pub. L. 96-499, title XI, Sec. 1122(a), signed Dec. 5, 1980.

[9] Sections 871(a)(1)(D) and 1441(b).

tax"[10] is imposed because a W-9 Form does not contain a valid taxpayer identification number.

The current U.S. withholding tax regime[11] provides that foreign financial institutions and fiscally transparent entities may enter into a Qualified Intermediary ("QI") agreement with the I.R.S. to limit the identification of the foreign beneficial owners of U.S. source fixed and determinable annual and periodic income. U.S. persons who are beneficial owners of an account opened with a QI must be reported to the I.R.S. and a Form 1099 must be issued. However, non-U.S. QI's have no reporting obligation with respect to U.S. customers who invest in non-U.S. bank accounts or non-U.S. securities.

In July 2008, the Senate Permanent Subcommittee on Investigations held hearings on use by U.S. persons of foreign accounts to hide income. In conjunction with the hearings, it issued a staff report dated July 17, 2008, on Tax Haven Banks and U.S. Tax Compliance which lists abuses of UBS and LGT banks. Among other things, the report stated that, in the period from 2001 to the date of the report, LGT and UBS collectively maintained thousands of U.S. client accounts with billions of dollars in assets that have not been disclosed to the I.R.S. Of these, UBS maintained an estimated 19,000 accounts in Switzerland for U.S. clients with assets valued at $18 billion and the I.R.S. identified at least 100 U.S. taxpayers with accounts at LGT.

Various legislative proposals were offered in the two years that followed the hearings and on March 18, 2010, President Obama signed into law the HIRE Act. The HIRE Act targets job creation by providing tax incentives to employers, such as business credits for newly hired employees. The revenue loss for the business credits was offset, in part, by a slightly modified version of the previously proposed Foreign Account Tax Compliance Act of 2009, ("FATCA"). FATCA imposes obligations on "foreign financial institutions" ("FFI's") and "nonfinancial foreign entities" ("NFFE's") to disclose to the I.R.S. offshore accounts or investments of U.S. persons. Failure to comply subjects FFI's and NFFE's to 30% withholding tax on certain payments that arise from U.S. sources directly and in certain cases on an apportioned basis.

b. Withholding Tax

Section 501 of the HIRE Act creates new §§1471 through 1474, which, collectively, impose a 30% withholding tax on "withholdable payments" made to FFIs, including QIs or to NFFEs if the FFI, QI or NFFE fails to comply with reporting and disclosure obligations. As a result, these rules create reporting, disclosure and withholding

[10] Section 3406.

[11] Reg. § 1.1441-1(e)(5).

obligations for U.S. withholding agents, multinational corporations, and FFIs that enter into FFI agreements with the I.R.S.

The foregoing obligations are subject to a grandfather provision, which exempts payments on, and the gross proceeds from the disposition of, obligations that were outstanding on March 18, 2012. Any withholdable payment of U.S. source fixed and determinable annual and periodical income made after December 31, 2013 to a nonparticipating FFI or to a recalcitrant NFFE is subject to the 30% withholding tax. If the withholdable payment is in the form of a "passthru payment," withholding begins on payments made after December 31, 2014. As enacted, the withholding obligations were to begin on payments made after December 31, 2012, but the due dates are postponed by Notice 2011-53.

A withholdable payment is defined in §1473. It is any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States, and any gross proceeds from the sale or other disposition of any property of a type which can give rise to interest or dividends from sources within the United States. Thus, in comparison to the withholding tax under §1441, sales proceeds of debt and equity securities will be potentially subject to the tax under §1471.

Withholding also applies to "passthru" payments from an FFI that has an agreement in place with the I.R.S. Passthru payments include both withholdable payments and payments attributable to withholdable payments. In the case of an attributable payment, withholding is applied to all or a portion of the payments that are made to a non-participating FFI or a recalcitrant NFFE. The concept of the passthru payment is designed to prevent noncompliant FFI's from avoiding FATCA withholding by making indirect investments in the U.S. through participating FFIs. Under Notice 2011-34, a payment made by an FFI (the "payor FFI") can be a passthru payment even if the payment is not directly a withholdable payment because the payment is not itself an item of U.S. source fixed and determinable annual and periodic income. Instead, a portion of the payment will be subject to withholding on a pro rata basis. The withholdable amount is determined by applying a "passthru payment percentage" to the payment. The payment may either (i) be made to a nonparticipating FFI or a recalcitrant NFFE by a participating FFI or (ii) received on behalf of a nonparticipating FFI or a recalcitrant NFFE by a participating FFI.

The passthru payment percentage is based on the value of the assets of the payor FFI. It is computed by (i) determining the sum of the FFI's U.S. assets held on each of the four quarterly testing dates and (ii) dividing that sum by the FFI's total assets held on those dates. The quarterly testing date is the last redemption date of the quarter for entities that conduct redemptions at least quarterly or the last business day of the quarter for all other entities. If a participating FFI makes the payment, the passthru percentage is based on the asset mix of the payor FFI. On the other hand, if

the participating FFI receives a payment on behalf of a nonparticipating FFI or a recalcitrant NFFE, the asset mix of the entity making the payment is use.

Many cross-border loan instruments are crafted to create net of tax arrangements for the lenders. In broad terms this means that the lenders are entitled to receive the agreed upon interest rate after all withholding taxes are taken out. This effectively means that the cost of the withholding tax is borne by the borrower. In anticipation of the effective date of FATCA withholding for non-participating FFIs, cross border loan instruments are now excluding FATCA withholding from the net of tax arrangement. This means that if the lender is a nonparticipating FFI withholding tax under FATCA is borne by that lender. Corollary of this change is that FFI's that are lenders are demanding the right to sell their participation or to call the loan in the event FATCA withholding tax becomes applicable.

c. FFI Defined

An FFI is defined as any foreign entity that:

i. Accepts deposits in the ordinary course of a banking or similar business;

ii. Is engaged in the business of holding financial assets for the account of others; or

iii. Is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading securities, interests in partnerships, commodities or any interest (including a futures or forward contracts or options) in such securities, partnership interests or commodities.

FFI's include foreign hedge funds, mutual funds and private equity funds, banks and brokerage firms. Insurance companies may be FFIs if they write policies that provide for an internal cash buildup. Thus, insurance companies that write whole life policies with cash surrender values or that write private placement policies would be FFIs. In comparison, companies that write only casualty policies likely are not FFIs.

d. Duty of an FFI

The withholding tax under FATCA is not an income tax in the classic sense because it is not designed as a mechanism to collect underlying income tax from a foreign entity. Rather, the FATCA withholding tax is a negative incentive to encourage FFIs to enter into agreements with the I.R.S. providing for the reporting of information on U.S. investors or account holders. Thus, §1471 provides that each FFI will be subject to the 30% withholding tax on "withholdable payments" unless it agrees to enter into an agreement with the I.R.S. containing the following terms:

i. To obtain information from each account holder as is necessary to determine which accounts are "U.S. accounts;"

ii. To comply with verification and due diligence procedures (to be prescribed by the I.R.S.) with respect to the identification of "U.S. accounts;" To report on an annual basis the information with respect to "U.S. accounts;"

iii. To deduct and withhold a 30% withholding tax on any pass-thru payment to a recalcitrant account holder or to another FFI which does not comply with the obligations imposed under Code Section 1471; To comply with requests by the I.R.S. for additional information with respect to any U.S. account maintained at the FFI; and

iv. To attempt to obtain a waiver from a foreign state if its laws prevent such disclosure, and to close the account if the waiver cannot be obtained.

Code Section 1471(c) provides that the information reporting requirements are satisfied and the 30% withholding tax can be avoided if the FFI reports the following information to the I.R.S.:

i. The name, address and U.S. taxpayer identification number of each account holder that is a U.S. person;

ii. The name, address and U.S. taxpayer identification number of each substantial U.S. owner of any account holder that is a U.S. owned foreign entity;

iii. The account number;

iv. The account balance or value (determined at such time and in such manner as the I.R.S. may provide); and

v. The gross receipts and withdrawals or payments from the account.

In general, a "U.S. account" is defined as any financial account which is held by one or more specified U.S. persons or U.S.-owned foreign entities. Section 1472 provides similar rules for withholdable payments made to NFFEs. Thus, the withholding agent must deduct a 30% withholding tax in the case of any withholdable payment made to a NFFE, unless all the following facts are present. First, the beneficial owner or payee must provide the withholding agent with (a) a certification that the beneficial owner or payee does not have a "substantial U.S. owner" or (b) the name,

address, and TIN of each substantial U.S. owner of such beneficial owner. Second, the withholding agent must not know, or have reason to know, that any information provided by the beneficial owner is incorrect. Finally, the withholding agent must report the information to the I.R.S. A substantial U.S. owner is a U.S. person that holds more than 10% of the foreign entity.

e. Due Diligence Requirements

FFIs and NFFEs face severe implementation challenges regarding the reporting obligations under the FACTA provisions. First, a very broad FFI definition exists. It includes banks, broker/dealers, hedge funds, private equity funds, collective and family investment vehicles, and securitization vehicles. All of these entities are required to design and implement an information system that can report on U.S. accounts and accounts with substantial U.S. owners. At a minimum, there are likely tens of thousands of FFI's that have invested in U.S. securities. All must comply. Substantial administrative burdens have been placed on the I.R.S. which must administer direct agreements with the FFIs and on the FFIs, themselves.

In this regard, the I.R.S. has issued guidance on the procedures that must be adopted to seek out U.S. direct and indirect investors. In Notices 2010-60, 2011-34, and 2011-53, the I.R.S. established procedures to be followed in order for an FFI to meet its due diligence obligations. If the FFI treats the account as a U.S. account for other U.S. tax purposes, the account is a U.S. account. Thus, for example, if a Form W-9 has been furnished with regard to an account, the account is a U.S. account. Similarly, if an account is subject to domestic back-up withholding tax, it is a domestic account. In comparison, pre-existing individual accounts with an aggregate balance of less than $50,000 in all related accounts are treated as non-U.S. accounts. Anecdotal evidence suggests that banks are already implementing these rules. FFIs are known to request Form W-9 for existing accounts that are known to have a U.S. individual as an ultimate beneficial owner.

Higher standards apply to accounts held with a private banking department of an FFI. A private banking department is a department that meets any one of several criteria:

i. It is referred to as a private banking, wealth management, or similar department, or

ii. It focuses on servicing accounts and investments of individual clients (or their families) whose accounts or whose income, earnings, or assets exceed certain thresholds ($500,000), or who are otherwise identified as high-net worth individuals (or families) under the internal policies of the FFI, or

iii. It is considered a private banking department under AML or KYC requirements to which the FFI is subject, or

iv. It ordinarily provides personalized services to individual clients (or their families), such as banking, investment advisory, trust and fiduciary, estate planning, philanthropic, or other services not generally provided to account holders, or

v. It ordinarily gathers information about individual clients' personal, professional, and financial histories in addition to the information ordinarily gathered with respect to retail customers.

If an FFI maintains a private banking department, specific obligations are imposed on the private banking relationship managers of the FFI. Each must identify any client known by the manager to be a U.S. person. For such clients, a Form W-9 (Request for Taxpayer Identification Number and Certification) must be requested.

If actual knowledge does not exist, the relationship manager must perform a diligent review of both paper and electronic account files – and other records, too – for each client and identify the clients (including any associated family members) having specified indicia of U.S. status. Such indicia include evidence of (i) U.S. citizenship, (ii) lawful permanent resident (green card) status, or (iii) U.S. birthplace. It also includes accounts having (a) a U.S. residence address, (b) a U.S. correspondence address, including a U.S. post office box, (c) standing instructions to transfer funds to an account maintained in the U.S., (d) directions regularly received from a U.S. address, (e) an "in care of" address or a "hold mail" address that is the sole address with respect to the client, or (f) a power of attorney or signatory authority granted to a person with a U.S. address.

The relationship manager must request a Form W-9 from each client identified as a U.S. citizen or lawful permanent resident. If the individual has a U.S. birth place or address but contends he or she is not a U.S. person, the relationship manager must request a Form W-8BEN and a non-U.S. passport establishing the client's citizenship outside the U.S. In addition, where there is U.S. birth place, the relationship manager must request a written explanation regarding the client's renunciation of U.S. citizenship or reason that the client did not acquire U.S. citizenship at birth. For the remaining indicia, the client must be requested to furnish the relationship manager with a Form W-8BEN establishing foreign status or W-9 establishing U.S. status. All persons who fail to provide documentation or to waive restrictions on disclosure are to be treated as recalcitrant account holders after the conclusion of the first year of the FFI agreement. Recalcitrant account holders are subject to 30% withholding on U.S. source fixed and determinable annual and periodic income and proceeds of sale of financial instruments that produce U.S. source dividends and interest income.

All information obtained must be included in an FFI report that must be submitted annually to the I.R.S. An ongoing obligation exists to update records. If a change

occurs to the status of a foreign account holder, certifications must be obtained. All records must be held for 10 years.

Other accounts must be searched electronically for indicia of U.S. status. Electronically searchable information refers to information that an FFI maintains in its tax reporting files, or customer master files or similar files. It is stored in the form of an electronic database against which standard queries in programming languages, such as Structured Query Language, may be used. Customer master files include an FFI's primary files for maintaining account holder information, such as information used for contacting account holders and for satisfying AML/KYC requirements. Information, data, or files are not electronically searchable merely because they are stored in an image retrieval system such as .pdf files or scanned documents.

If, for the other accounts, indicia of U.S. status exist, the existing client must be contacted within one year after the FFI agreement becomes effective to request information of a kind described above. Account holders that have not provided appropriate documentation within two years of the effective date of the FFI agreement will be classified as recalcitrant account holders until appropriate documentation is received.

3. Individual Disclosure of Foreign Financial Assets

a. Context

New §6038D is all about how the I.R.S. deals internally with Form TD 90-22.1 (Report Of Foreign Bank And Financial Accounts) ("the FBAR Form").

Until 2003, the Financial Crimes and Enforcement Network ("FinCEN"), an agency of the Department of the Treasury, had responsibility for civil penalty enforcement of the FBAR Form. Persons who were more than 180 days delinquent in paying any FBAR penalties were referred for collection action to the Financial Management Service of the Treasury Department, which is responsible for such non-tax collections. Continued nonpayment resulted in a referral to the Department of Justice for institution of court proceedings against the delinquent person.

In 2003, civil enforcement was delegated to the I.R.S. This change was made because a major purpose of the FBAR Form was to identify potential tax evasion, which was not closely aligned with FinCEN's core mission. The authority delegated to the I.R.S. in 2003 included the authority to determine and enforce civil penalties, as well as to revise the form and instructions. However, the collection and enforcement powers available to enforce the Internal Revenue Code under Title 26 do not apply to the enforcement of FBAR Form civil penalties, which remain collectible only in accordance with the procedures for non-tax collections described

above. New §6038D is intended to provide an information form that can be enforced by the I.R.S. without eliminating the FBAR Form.

b. Information Reporting

Section 511 of the HIRE Act adds §6038D, which provides that any U.S. taxpayer who, at any time during the taxable year, holds any interest in "specified foreign financial assets" totaling $50,000 or more (or such higher amount as the I.R.S. may prescribe) must include a disclosure statement on his annual income tax return. In essence, the new provision is the first of many new reporting obligations imposed on taxpayers and enforceable by significant penalties. When combined with FATCA reporting obligations imposed on FFIs and the penalty withholding taxes that serve as a negative incentive to compliance, a compliance pincer is created. Information is obtainable from foreign institutions to check on the information required of U.S. persons.

Specified foreign financial assets include:

i. Any financial account maintained by a foreign financial institution and assets held outside of a foreign financial institution;

ii. Any stock or security issued by a non-U.S. person;

iii. Any financial instrument or contract held for investment that has an issuer or counterparty which is other than a U.S. person; and

iv. Any interest in a foreign entity (possibly including holding U.S. publicly traded stock in a foreign corporation).

Any U.S. taxpayer who fails to furnish information on his annual income tax return is subject to a penalty of $10,000. An additional $10,000 penalty is due for every 30 days the failure to file persists longer than 90 days after the taxpayer is informed of such failure, up to a maximum of $50,000. However, no penalty will be imposed if the failure to furnish such information is due to reasonable cause and not due to willful neglect.

This section of the HIRE Act is effective for taxable years beginning after March 18, 2010. The filing is made on Form 8938 (Statement of Specified Foreign Financial Assets), which has not been published in final form as of the date of this paper. In Notice 2011-55, the I.R.S. suspended the reporting requirements under §6038D until a final Form 8938 is released. Once the final version of Form 8938 is released, reporting will be required retroactively on a form that is attached to the next following tax year.

Although Form 8938 is not identical to the FBAR, the two forms are very similar; consequently the additional form will cause duplication of the reporting to many taxpayers. However, because the forms are not identical, different definitions of terms, filing procedures, and deadlines are expected to increase and complicate the filing requirements of many taxpayers and unnecessarily expose taxpayers to inadvertent violations of their compliance responsibilities.

4. Understatement Penalty for Failure to Disclose Foreign Assets

a. Context

The Code imposes penalties equal to 20% percent of the portion of any underpayment of tax that is attributable to any of the following:

i. Negligence or disregard of rules or regulations;

ii. Any substantial understatement of income tax;

iii. Any substantial valuation misstatement;

iv. Any substantial overstatement of pension liabilities; and

v. Any substantial estate or gift tax valuation understatement.

With the exception of a penalty based on negligence or disregard of rules or regulations, these penalties are commonly referred to as accuracy-related penalties, because the imposition of the penalty does not require an inquiry into the culpability of the taxpayer. If the penalty is asserted, a taxpayer may defend against the penalty by demonstrating that (1) there was "reasonable cause" for the underpayment and (2) the taxpayer acted in good faith.[12] Regulations provide that reasonable cause exists in cases in which the taxpayer "reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the I.R.S.[13] The penalty may be reduced to the extent of the portion of the understatement attributable to an item on the return for which the challenged tax treatment (i) is supported by substantial authority or (ii) is adequately disclosed on the return and there was a reasonable basis for such treatment. In no event is the defense available with respect to penalties imposed on understatements arising from tax shelters.[14] The

[12] Section 6664(c).

[13] Reg. §§. 1.6662-4(g)(4)(i)(B) and 1.6664-4(c).

[14] Section 6662(d)(2)(C).

I.R.S. may prescribe a list of positions that do not meet the requirements for substantial authority under this provision.

A failure to comply with an information reporting requirement generally does not, in itself, determine the amount of the penalty imposed on an underpayment of tax. However, such failure to comply may be relevant for establishing negligence under §6662 or fraudulent intent for purposes of the 75% fraud penalty under §6663. It may also be relevant for purposes of determining whether penalties based on culpability are applicable or whether certain defenses are available.

b. Penalty

Section 512 of the HIRE Act amended §6662 to provide that if a U.S. person understates income that is related to an "undisclosed foreign financial asset," then such person will be subject to a 40% penalty. An undisclosed foreign financial asset is defined as any asset for which information was not properly provided but is required to be disclosed as a specified foreign asset or under any other provisions of the Code.

This section of the HIRE Act is effective for taxable years beginning after March 18, 2010.

5. Statute of Limitations for Substantial Omissions

a. Context

Taxes are generally required to be assessed within three years after a taxpayer's return was filed, whether or not it was timely filed.[15] Of the exceptions to this general rule, only §6501(c)(8) is specifically targeted at the identification of, and collection of information about, cross-border transactions. Under this exception, the limitation period for assessment of any tax imposed under the Code with respect to any event or period to which information about certain cross-border transactions required to be reported relates does not expire any earlier than three years after the required information is actually provided to the I.R.S. by the person required to file the return. Required information reporting subject to this three-year rule includes reporting under §6038 (certain foreign corporations and partnerships), §6038A (certain foreign-owned corporations), §6038B (certain transfers to foreign persons), §6046 (organizations, reorganizations, and acquisitions of stock of foreign corporations), §6046A (interests in foreign partnerships), and §6048 (certain foreign trusts). In general, such information reporting is due with the taxpayer's return. For these items the three-year limitation period commences when a timely and complete (including all information reporting) return is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are submitted to the I.R.S.

[15] Section 6501(a).

A special rule is provided where there is a substantial omission of income, as defined. If a taxpayer omits substantial income on a return, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed. In the case of income taxes, substantial means at least 25% of the amount that was properly includible in gross income. For estate and gift taxes, it means 25 percent of a gross estate or total gifts. For this purpose, the gross income of a trade or business means gross receipts, without reduction for the cost of sales or services.[16] An amount is not considered to have been omitted if the item properly includible in income is disclosed on the return. In determining whether an amount was omitted, any amounts that are disclosed in the return or in a statement attached to the return in a manner adequate to apprise the Secretary of the nature and amount of such item are not taken into account.

b. Extension of Limitations Period

Section 513 of the HIRE Act amended §6501(e) to provide an extension of the statute of limitations to six years for significant omissions of income that is derived from specified foreign assets in an amount exceeding $5,000 in any taxable year. The exception applies if there is an omission of gross income in excess of $5,000 and the omitted gross income is attributable to an asset with respect to which information reports are required under §6038D, as applied without regard to the dollar threshold, the statutory exception for nonresident aliens and any exceptions provided by regulation. If a domestic entity is formed or availed of to hold foreign financial assets and is subject to the reporting requirements of §6038D in the same manner as an individual, the six-year limitations period may also apply to that entity. The Secretary is permitted to assess the resulting deficiency at any time within six years of the filing of the income tax return.

Section 218 of the Education Jobs and Medicaid Assistance Act modified the application of this extended statute of limitations. Where the failure to provide information on cross-border transactions or foreign assets was due to reasonable cause and not to willful neglect, the statute of limitations would be tolled only for items related to the late-supplied information and not to all items on the return. The legislative history indicated that related items would include tax consequences of the transaction (or asset) that was the subject of the information return, other affected items, and related interest and penalties.

Section 513 of the HIRE Act is effective for tax returns filed after March 18, 2010 and for returns filed on or before March 18, 2010 if the assessment period for such tax returns has not expired. The amendment to §6501(c)(8) is effective on the same dates, as if included in HIRE Act Section 513.

[16] Section 6501(e)(1)(A)(i).

6. Reporting of Activities with Respect to P.F.I.C.s

a. Context

In general, active foreign business income derived by a foreign corporation with U.S. owners is not subject to current taxation in the U.S. for those owners until the corporation distributes a dividend. Certain rules, however, restrict the benefit of deferral of U.S. tax on income derived through foreign corporations. One such set of rules is Subpart F, which applies to 10% or greater shareholders of controlled foreign corporations generating foreign base company income.[17] Another such regime applies to U.S. persons who own stock of a passive foreign investment companies ("P.F.I.C."). A P.F.I.C. generally is defined as any foreign corporation if 75% percent or more of its gross income for the taxable year consists of passive income, or 50% or more of its assets produce, or are held for the production of, passive income.[18] Various sets of income inclusion rules apply to U.S. persons that are shareholders in a P.F.I.C., and percentage of ownership in the company is not relevant for their application. One set of rules allows shareholders to defer income, but whenever income or gain is recognized imposes high tax rates on the income plus an interest charge on deemed deferral.[19] A second set of rules applies to a P.F.I.C. that is a qualified electing fund ("QEF"). Under this set of rules, U.S. shareholders may elect to be taxed currently on the income and gains of the QEF. Tax is imposed on the amounts included at ordinary or long-term capital gains rates and no interest charge is imposed. A separate election may be made to defer payment of tax on income not currently received. The deferred tax is subject to an interest charge.[20] A third set of rules applies to marketable P.F.I.C. stock, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and the adjusted basis in such stock. This rule is often referred to as a mark-to-market inclusion.[21]

In general, a U.S. person that is a direct or indirect shareholder of a P.F.I.C. must file I.R.S. Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund" for each tax year in which that (i) gain is recognized as a result of a direct or indirect disposition of P.F.I.C. stock, (ii) certain

[17] Sections 951 to 964.

[18] Section 1297.

[19] Section 1291.

[20] Sections 1293-1295.

[21] Section 1296.

direct or indirect distributions are received from a P.F.I.C., or (iii) a reportable election is made. According to the instructions to Form 8621, reportable elections include:

i. An election to treat the P.F.I.C. as a QEF;

ii. An election to recognize gain on the deemed sale of a P.F.I.C. interest on the first day of the PFIC's tax year as a QEF;

iii. An election to treat an amount equal to the shareholder's post-1986 earnings and profits of a controlled foreign corporation as an excess distribution on the first day of a P.F.I.C.'s tax year as a QEF that is also a controlled foreign corporation;

iv. An election to extend the time for payment of the shareholder's tax on the undistributed earnings and profits of a QEF;

v. An election to treat as an excess distribution the gain recognized on the deemed sale of the shareholder's interest in the P.F.I.C., or to treat such shareholder's share of the P.F.I.C.'s post-1986 earnings and profits as an excess distribution, on the last day of its last tax year as a P.F.I.C. under Section 1297(a) if eligible; or

vi. An election to mark to market the PFIC stock that is marketable within the meaning of section 1296(e).

The Code includes a general reporting requirement for certain P.F.I.C. shareholders which is contingent upon the issuance of regulations.[22] Although the I.R.S. issued proposed regulations[23] in 1992 requiring U.S. persons to file Form 8621 annually for each P.F.I.C. of which the person is a shareholder, the proposed regulations have not been finalized and the instructions to Form 8621 require reporting only if a triggering event occurs.

b. Annual Reporting

Section 521 of the HIRE Act amended §1298 to require that a U.S. person who is a shareholder in a P.F.I.C. must file a Form 8621 on an annual basis. A person that meets the reporting requirements of this provision may also meet the reporting requirements of Section 511 of the HIRE Act and §6038D of the Code requiring disclosure of information with respect to foreign financial assets. The legislative

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[22] Section1291(e), which refers to repealed Section 1246(f).

[23] Prop. Reg.§1.1291-1(i).

history anticipates that the I.R.S. will exercise regulatory authority to avoid duplicative reporting.

This section of the HIRE Act is effective on March 18, 2010.

7. Presumption – Foreign Trust has U.S. Beneficiaries

a. Context

Under the grantor trust rules, a U.S. person that directly or indirectly transfers property to a foreign trust is generally treated as the owner of the portion of the trust comprising the transferred property for any taxable year in which there is a U.S. beneficiary of any portion of the trust.[24] A trust is a foreign trust if it is not a U.S. domestic trust.[25] A trust is a U.S. domestic trust if a U.S. court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.[26] This treatment generally does not apply to transfers by reason of death, or to transfers of property to the trust in exchange for at least the fair market value of the transferred property.[27]

A trust is presumed to have a U.S. beneficiary for the taxable year unless two facts exist. First, under the terms of the trust instrument, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person. Second, if the trust were terminated during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.[28] Regulations under §679 employ a broad approach in determining whether a foreign trust is treated as having a U.S. beneficiary. In considering whether a foreign trust has a U.S. beneficiary under the terms of the trust, the trust instrument must be read together with other relevant factors including:

i. All written and oral agreements and understandings related to the trust,

ii. Memoranda or letters of wishes,

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[24] Section 679(a)(1).

[25] Section 7701(a)(31)(B).

[26] Section 7701(a)(30)(E).

[27] Section 679(a)(2).

[28] Section 679(c)(1).

iii. All records that relate to the actual distribution of income and corpus, and

iv. All other documents that relate to the trust, whether or not of any purported legal effect.[29]

Other factors may also be taken into account. These other factors include whether (a) the terms of the trust allow the trust to be amended to benefit a U.S. person, (b) the trust instrument does not allow such an amendment, but the law applicable to the foreign trust may require payments or accumulations of income or corpus to a U.S. person, and (c) the parties to the trust ignore the terms of the trust, or it is reasonably expected that they will do so to benefit a U.S. person.[30]

If a foreign trust that was not treated as a grantor trust acquires a U.S. beneficiary and is treated as a grantor trust under §679 for the taxable year, the transferor is taxable on the trust's undistributed net income computed at the end of the preceding taxable year.[31] Any additional amount included in the transferor's gross income as a result of this provision is subject to the interest charge rules of §668.[32]

b. Presumption

Sections 531 and 532 of the HIRE Act amended §679 to clarify that an amount is to be treated as accumulated for the benefit of a U.S. person where a U.S. person is a contingent beneficiary. In addition, with respect to a discretionary trust, the trust will be treated as having a U.S. beneficiary if any person has the discretionary power to make a distribution from the trust to, or for the benefit of, any person unless the terms of the trust specifically identify the class of persons to whom such distributions may be made, and none of said persons is a U.S. person during the taxable year. The provision clarifies that if any U.S. person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding (whether written, oral, or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a U.S. person, such agreement or understanding is treated as a term of the trust. It is assumed for these purposes that a transferor of property to the trust is generally directly or indirectly involved with agreements regarding the accumulation or disposition of the income and corpus of the trust. Finally, the I.R.S. may treat a foreign trust as having a U.S. beneficiary for purposes of §679 unless sufficient

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[29] Reg. §1.679-2(a)(4)(i).

[30] Reg. §1.679-2(a)(4)(ii).

[31] Section 679(b).

[32] Reg. §1.679-2(c)(1).

information is submitted to the I.R.S. indicating that the facts demonstrate an absence of a U.S. beneficiary.

This section of the HIRE Act is effective for taxable years beginning after March 18, 2010.

8. Reporting Requirement of U.S. Owners of Foreign Trusts and Related Penalties

a. Context

Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. If a U.S. person is treated as the owner of any portion of a foreign trust, the U.S. person is responsible for ensuring that the trust files an information return for the year and that the trust provides other information, required by the I.R.S., to each U.S. person who is treated as the owner of any portion of the trust, or receives (directly or indirectly) any distribution from the trust.

In addition, if a notice or return required under the rules just described is not filed when due or is filed without all required information, the person required to file is generally subject to a penalty based on the "gross reportable amount."[33] The gross reportable amount is:

i. The value of the property transferred to the foreign trust if the delinquency is failure to file notice of the creation of or a transfer to a foreign trust;

ii. The value (on the last day of the year) of the portion of a grantor trust owned by a U.S. person who fails to cause an annual return to be filed for the trust; and

iii. The amount distributed to a distributee who fails to report distributions.[34]

The initial penalty is 35% of the gross reportable amount in the first and third fact patterns and 5% in the second fact pattern. [35] If the return is more than 90 days late, additional penalties are imposed of $10,000 for every 30 days the delinquency continues, except that the aggregate of the penalties may not exceed the gross reportable amount.

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[33] Section 6677(c).

[34] *Id.*

[35] Section 6677(b).

b. Reporting and Penalties

Sections 534 and 535 of the HIRE Act expanded the current trust reporting requirements and modified the current trust reporting penalties. Section 534 of the HIRE Act amended §6048(b) to provide that a U.S. person who is treated as the owner of any portion of a foreign trust under grantor trust provisions must provide information returns as required with respect to the trust, in addition to ensuring that the trustee of the trust complies with reporting requirements.

This section of the HIRE Act is effective for taxable years beginning after March 18, 2010.

Section 535 of the HIRE Act amended §6677(a) to increase the penalty for failing to timely file information returns related to certain foreign trusts. If the reporting obligations are not met, a minimum penalty of at least $10,000 applies. The 35% and 5% penalties apply if they are greater than $10,000. To the extent that a taxpayer provides sufficient information for the I.R.S. to determine that the aggregate amount of the penalties exceeds the gross reportable amount, the Secretary is required to refund such excess to the taxpayer.

This section of the HIRE Act is effective for information returns required to be filed after December 31, 2009.

9. Uncompensated use of Trust Property

a. Context

Under §643(i), a loan of cash or marketable securities made by a foreign trust to any U.S. grantor, U.S. beneficiary, or any other U.S. person who is related to a U.S. grantor or U.S. beneficiary generally is treated as a distribution by the foreign trust to such grantor or beneficiary. Where the borrower is related to both the U.S. grantor and the U.S. beneficiary, the party having the income is to be determined under regulations.[36] To date, no regulations have been issued under §643(i). This rule applies for purposes of determining if the foreign trust is a simple or complex trust, computing the distribution deduction for the trust, determining the amount of gross income of the beneficiaries, and computing any accumulation distribution. Loans to tax-exempt entities are excluded from this rule.[37] A trust treated under this rule as making a distribution is not treated as a simple trust for the year of the

[36] §643(i)(2)(B)(ii).

[37] §643(i)(2)(C).

distribution.[38] This rule does not apply for purposes of determining if a trust has a U.S. beneficiary under section 679.

A subsequent repayment, satisfaction, or cancellation of a loan treated as a distribution under section 643(i) is disregarded for tax purposes.[39] This prevents the borrowing beneficiary from being viewed as a grantor with regard to a portion of the trust.

This section applies a broad set of related party rules that treat a loan of cash or marketable securities to a spouse, sibling, ancestor, descendant of the grantor or beneficiary, other trusts in which the grantor or beneficiary has an interest, and corporations or partnerships controlled by the beneficiary or grantor or by family members of the beneficiary or grantor, as a distribution to the related grantor or beneficiary. In essence, the relationship provisions of §§267 and 707(b) are broadened to include the spouses of members of the family described in such sections.

When §643(i) was originally proposed during the Clinton Administration, the provision was intended to apply to all uses of trust property by beneficiaries where arm's length consideration was not paid. However, the scope was reduced in the bill that was enacted so that it applied only to loans of cash and marketable securities.

b. Expansion to Other Property

Section 533 of the HIRE Act expanded the scope of §643(i) to provide that any use of trust property by the U.S. grantor, U.S. beneficiary or any U.S. person related to a U.S. grantor or U.S. beneficiary is treated as a distribution of the fair market value of the use of the property to the U.S. grantor or the U.S. beneficiary. The use of property is not treated as a distribution to the extent that the trust is paid the fair market value for the use of the property within a reasonable period of time. A subsequent return of property treated as a distribution under section 643(i) is disregarded for tax purposes.

For purposes of determining whether a foreign trust has a U.S. beneficiary under §679, a loan of cash or marketable securities or the use of any other trust property by a U.S. person is treated as a payment from the trust to the U.S. person in the amount of the loan or the fair market value of the use of the property. A loan or use of property is not treated as a payment to the extent that the U.S. person repays the loan at a market rate of interest or pays the fair market value for the use of the trust property within a reasonable period of time. No guidance is provided regarding the measurement of fair market value where the property furnished by the foreign trust

[38] §643(i)(2)(D).

[39] §643(i)(3).

is real property, such as a condominium, and the use is sporadic. One approach is to measure the rental value for an entire year and then determine the value attributable to daily usage. This approach would seem to have merit if more than one beneficiary uses the condominium. The merit would likely be enhanced if usage is limited to a set number of days under a formal decision taken by the trustee. On the other hand, if only one beneficiary has access to the condominium and that beneficiary keeps belongings in the unit on a full-time basis, an approach which measures value based on a continuous rental period would seem to be more appropriate.

10. Substitute Payments

a. Context

Payments of U.S. source "fixed or determinable annual or periodical" income – including interest, dividends, and similar types of investment income – made to foreign persons are generally subject to U.S. tax, collected by withholding, at a 30% rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[40] Dividends paid by a domestic corporation are generally U.S.-source and therefore potentially subject to withholding tax when paid to foreign persons. The source of notional principal contract ("NPC") income generally is determined by reference to the residence of the recipient of the income.[41] An NPC is a financial instrument that provides for the payment of amounts by one party to another, at specified intervals and calculated by reference to a specified index applied to a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts. These contracts, known in the financial industry as swaps, are used to hedge against risks, such as fluctuations in interest rates, currency values, and commodity prices.[42] Consequently, a foreign person's income related to an NPC that references stock of a domestic corporation, including any amount attributable to, or calculated by reference to, dividends paid on the stock, generally is considered to arise from foreign sources and is therefore not subject to U.S. withholding tax.

In contrast, a substitute dividend payment made to the transferor of stock in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as actual dividends paid on the transferred stock.[43] A substitute

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[40] Sections 871, 881, 1441, and 1442; and Reg. §1.1441-1(b).

[41] Reg. §1.863-7(b)(1).

[42] Reg. §1.446-3(c)(1).

[43] Reg. §1.861-3(a)(6).

dividend payment is a payment made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction which is equivalent in amount to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.

Accordingly, if dividends paid with respect to the stock of a U.S. company constitute U.S. source income when the shares of stock are loaned by a foreign person to another person (or a foreign person sells the stock to the other person and later repurchases the stock in a transaction treated as a loan for U.S. federal income tax purposes), the resulting substitute payment received by the foreign lender of stock is U.S. source income, too. Consequently, it is generally subject to U.S. withholding tax.[44]

In 1997, the I.R.S. issued Notice 97-66 to address concerns that the sourcing rule just described could cause the total U.S. withholding tax imposed in a series of securities lending or sale-repurchase transactions to be excessive. In the Notice, the I.R.S. stated that it intended to propose new regulations to provide detailed guidance on how substitute dividend payments made by one foreign person to another foreign person were to be treated. To date, no regulations have been proposed. Nonetheless, some have interpreted the Notice as eliminating all withholding tax in properly structured transactions. This is an important element when a financial institution creates an electronically traded fund or ETF consisting of a basket of physical securities. The dividends paid on the physical securities issued by U.S. corporations are subject to withholding taxes. However, the payments on the ETF are not.

b. Imposition of Withholding Tax on Substitute Payments

Section 541 of the HIRE Act enacted what is now §871(m), which changed the U.S. source and character rules for dividend equivalent payments on specified NPCs, such as equity swaps. However, this section does not change the rules with respect to interest rate swaps, currency swaps, credit default swaps and other NPCs. Now, dividend equivalent payments will be considered to be U.S. source income subject to the 30% withholding tax absent a treaty benefit. Consequently, the treatment of actual dividends and dividend equivalent payments is consistent.

Under §871(m)(2), a dividend equivalent is defined as:

i. Any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the U.S.;

[44] Reg. §§1.871-7(b)(2) and 1.881-2(b)(2).

ii. Any payment made pursuant to a specified NPC that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the U.S.; and

iii. Any other payment determined by the I.R.S. to be substantially similar to either of the foregoing payments.

Dividend equivalent payments are to be computed on a gross rather than a net basis.[45]

Two definitions of a specified NPC as part of a phase-in of the new rules[46] The first definition is for payments made on or after September 14, 2010, the effective date of the change in the source rule. As of that time, a specified NPC is any NPC that meets any one of the following five tests:

i. In connection with entering into such contract, any long party to the contract transfers the underlying security to any short party to the contract;

ii. In connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract;

iii. The underlying security is not readily tradable on an established securities market;

iv. In connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract; or

v. Such contract is identified by the I.R.S. as a "specified notional principal contract."

After March 18, 2012, a specified NPC is any NPC unless the I.R.S. determines that the contract is of a type that does not have the potential for tax avoidance.

In order to address demonstrated incidents of double withholding of U.S. tax, §871(m)(6) provides that, in the case of any chain of dividend equivalents, one or more of which is subject to tax under §871(m) or §881, the I.R.S. has the option to reduce the tax if – and only to the extent that – the taxpayer can establish that

[45] Section 871(m)(5).

[46] Section 871(m)(3).

withholding tax has been paid with respect to another dividend equivalent payment in the chain, or is not otherwise due. In addition, the I.R.S. may alleviate the problem in whatever fashion it determines is appropriate to address the role of financial intermediaries in a chain.

11. Allocating Interest Expense-Modification of Affiliation

a. *Context*

For purposes of allocating and apportioning interest expense to taxable income, an affiliated group is treated as a single taxpayer.[47] Under the prior statute, a foreign corporation was ineligible for group membership.[48] Nevertheless, regulations treated a foreign corporation as a group member for interest allocation and apportionment purposes, if one or more members of a U.S. group directly or indirectly owned at least 80% of either the voting power or value of its stock, and more than 50% of its gross income for the year was effectively connected to a U.S. trade or business ("ECI").[49] Less stock ownership was required under this rule than under the statutory definition of an affiliated group, which required that group members *directly* own at least 80% of each other member's stock by *both* vote and value.[50] The rule therefore made it easier, in part, to be treated as a member of a U.S. affiliated group for purposes of allocating interest expense to domestic corporations and foreign corporations described in the test. This eliminated planning opportunities in which U.S. source income and debt could be stuffed into a foreign special purpose vehicle in order enhance the foreign tax credit limitation of the U.S. members.

b. Apportionment Methodology

Section 216 of the Education Jobs and Medicaid Assistance Act enacted new §865(e)(5)(A), which codifies temporary regulations issued by the I.R.S. For purposes of allocating and apportioning the interest expense of affiliated group members, a foreign corporation is now generally treated as a member if another member owns at least 80% of its stock by either vote or value and the corporation has at least 50% ECI.[51] This provision applies "[n]otwithstanding the preceding sentence" of the same subparagraph, which generally adopts the definition of an

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[47] Section 865(a)(1), (e)(5)(A)(first sentence).

[48] *Id.*; § 1504(b)(3).

[49] Temp. Reg. § 1.861-11T(d)(6)(ii).

[50] Section 1504(a)(1)(B)(ii), (a)(2).

[51] Section 865(e)(5)(A) (added second sentence).

affiliated group in Section 1504(b), thereby precluding foreign corporations from group membership. Since all the assets of a corporation that is an affiliated group member by statute must be taken into account for interest allocation and apportionment purposes, all of such a foreign group member's assets will now be available to treat group interest expense as U.S.-source. This should eliminate foreign tax credit benefits that were obtainable in principle when assets and debts are stuffed into a foreign corporation that is a special purpose vehicle having effectively connected income. Because that foreign corporation will be part of the group when computing the amount of interest expense that is allocated to group foreign source income, the benefit of the stuffing exercise will be lost. The provision applies to tax years beginning after August 10, 2010.[52]

12. 80-20 Corporations.

a. Context

Interest and dividend income is usually sourced to the payor's home country.[53] Dividends or interest paid by a U.S. payor to a foreign recipient is therefore generally treated as U.S-source income, subject to U.S. withholding tax.[54] Under prior law, this rule was altered if a resident alien paying interest or a U.S. corporation paying interest or dividends met an "80-20 test." A corporation meeting the test was referred to as an "80-20" corporation. The test required that at least 80% of such person's gross income be foreign-source income attributable to the active conduct by that person (or by a 50% corporate-owned subsidiary) of a trade or business in a foreign country or U.S. possession.[55] The test was applied during a three-year testing period, generally ending in the year prior to the payment.[56]

The effect of the special rules applicable to payments from an 80-20 corporation varied according to the type of payment made and the relationship between the payor and the recipient. Interest paid to an unrelated person was treated as entirely foreign-source income for the recipient. Therefore, it was entirely exempt from U.S. withholding tax. The source of interest income paid to a related party recipient was resourced only in proportion to the percentage that the payor's foreign-source income 'bore to its total gross income during a testing period.[57] Dividends became

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[52] Section 216, Pub. L. 111-226.

[54] Sections 871(a)(1)(A), 881(a)(1), 1441(b), 1442(a).

[55] Former § 861(a); § 861(c)(1).

[56] Section 861(c)(1)(C).

[57] Section 861(c)(2).

exempt from withholding to the same extent as related-person interest payments, but remained U.S.-source.[58] Consequently, the resourcing of interest and treating dividends from an 80-20 corporation as exempt income allowed these outbound payments made by U.S. persons to escape withholding tax even in the absence of an income tax treaty benefitting the recipient.

b. Scale-back of 80-20 Benefits

Section 217 of the Education Jobs and Medicaid Assistance Act modified §§861(a)(1), 871(i)(2)(B) and 871(l). The provision generally eliminated the prior-law 80-20 test and its effects,[59] for tax years beginning after 2010.[60] Some U.S. corporations, however, are grandfathered, albeit with less generous benefits. Grandfathering applies if the corporation met the prior 80-20 test in its last tax year beginning before 2011, meets a new 80-20 test for each tax year beginning after 2010, and did not add a substantial line of business after August 10, 2010.[61]

A grandfathered 80-20 corporation will be exempt from withholding on a certain percentage of its outbound interest and dividend payments. However, unlike the ratio that determined the eligible percentage of related-party interest and dividend payments under prior law, this one will be reduced by a smaller numerator: active foreign business income (not all foreign-source income) as a percentage of all gross income.[62] For purposes of calculating the exempt percentage, the 80-20 corporation and all of its subsidiaries, both domestic and foreign, are treated as a single corporation. This is intended to prevent existing 80-20 corporations from creating new subsidiaries into which non-active assets and income are stuffed. Subsidiaries will be defined as corporations 50% of the vote and value of which is directly or indirectly owned by the 80-20 corporation.[63] Interest as well as dividends, moreover, will be treated as U.S.-source even if exempt.

When the three-year testing period includes a tax year beginning before 2011, a transition rule imposes a further limitation. The transition rule divides the three-year testing period into two portions, one for tax years beginning before 2010 and one for tax years beginning thereafter. For each, the corporation must determine

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[58] Former § 871(i)(2)(B).

[59] Former §861(a)(1)(A) has been eliminated.

[60] Section 217(d)(1), Pub. L. 111-226.

[61] Section 871(l)(1)(A).

[62] Section 871(l)(2).

[63] Section 871(l)(3).

the percentage of its gross income constituting active foreign business income, using the subsidiary aggregation rule for post-2010. If the percentage for each portion is at least 80%, the dividend or interest expense treated as exempt will be the weighted average of the two.[64]

13. Income from Guarantees.

a. Context

When neither Code source rules nor regulations address a specific item of income, courts have sometimes sourced the item by analogy to other similar income items. In a recent case, *Container Corp. v. Commissioner*,[65] the I.R.S. argued that a U.S. subsidiary should have withheld 30% from fees paid to its Mexican parent for guarantee of a subsidiary debt, because the fees were analogous to interest. The Tax Court disagreed, analogizing the fees to services because the parent only promised to pay if the subsidiary defaulted and performance would be based on the parent's assets and its reputation in Mexico. Accordingly the court sourced the fees as foreign, based on the guarantor's residence.

Congress was concerned that taxpayers would try to avoid withholding tax by using the fact pattern in the case to structure loan guarantees.

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[64] Section 871(l)(1)(B)(iv).

[65] 134 T.C. No. 5 (February 17, 2010), *aff'd per curiam in unpub. opin.,* No. 10-60515 (5th Cir. June 1, 2010).

b. Change in Source Rule

Section 2122 of Small Business Jobs Act enacted §861(a)(9), which provides that any amount received directly or indirectly for guaranteeing an obligor's indebtedness will be treated as U.S.-source income if received directly or indirectly from a U.S. resident or U.S. corporate obligor, or from a foreign obligor if the amount received is (or is treated as) effectively connected with a U.S. trade or business and is ECI.[66] In a rather unusual exercise of logic, the legislative history indicates that if a foreign bank paid a fee to a foreign corporation for guaranteeing a loan by the bank to the corporation's U.S. subsidiary, the fee would be treated as U.S. source if passed through to the subsidiary, for example, by additional interest on the loan.[67] Why a guaranteed loan would bear a rate of interest that is higher than an unguaranteed loan is a question that begs asking. Perhaps, the Joint Committee Staff believes that the transfer pricing rules of §482 are not enforceable.

The provision applies to guarantees issued after September 20, 2010.[68] Therefore, *Container Corp.* may still support foreign source treatment of fees paid to foreign guarantors for guarantees issued before that date.

14. Treatment of certain RIC dividends.

a. Context

The income of a RIC, 90% of which must be distributed to its shareholders, is taxed to the shareholders as dividends, which are deductible by the RIC. RIC dividends paid to foreign persons are generally subject to a 30% gross-basis tax[69] and the RIC has the obligation to collect the tax through withholding.[70]

However, to the extent a RIC earns interest income that would not be taxable if earned directly by a foreign person, it may designate the appropriate portion of its

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[66] *See also* §§ 862(a)(9) and 864(c)(4)(B)(ii).

[67] Joint Committee on Taxation, *Technical Explanation of the Tax Provisions in Senate Amendment 4594 to H.R. 5297, the "Small Business Jobs Act of 2010," Scheduled for Consideration by the Senate on September 16, 2010,"* September 16, 2010 (JCX-47-10), available at www.jct.gov., at 48-50.

[68] Section 2122(d), Pub. L. 111-240.

[69] Sections 871(k), 881.

[70] Sections 1441, 1442.

dividends as having been derived from such income. Foreign persons may treat the designated portion of RIC dividends as exempt from gross-basis taxation and associated withholding. Provided it meets certain requirements, the RIC will be relieved, in such circumstances, from its duty to withhold. Certain short-term capital gains support similar dividend designations, with similar tax results. The provision had a built-in two-year life, calling for it to lose effect for RIC tax years beginning after 2009.

b. Two-year Extension

Section 748 of the Tax Relief, Unemployment Reauthorization and Job Creation Act continues the exemption from gross-basis taxation and withholding on interest-related and short-term capital gain dividends by amending §871(k)(1)(C) and (2)(C). The extension is for two RIC tax years. The tax benefit terminates with RIC tax years beginning after December 31, 2011.

15. RIC Qualified Investment Entity Treatment under FIRPTA

a. Context

A foreign individual or corporation without a certain nexus to the United States (physical presence or a U.S. trade or business) generally is not taxed on U.S.-source capital gains. However, a foreign person's gain on disposition of a "U.S. real property interest" ("USRPI") is treated as ECI and therefore is taxed under the F.I.R.P.T.A.,[71] with withholding imposed to ensure collection of the tax.[72]

USRPIs did not include interests in domestically-controlled RICs, treated under prior law as "qualified investment entities" ("QIEs"). Gains from distributions of interests in such RICs escaped F.I.R.P.T.A. tax and the related withholding. A distribution with respect to an interest in a RIC, attributable to a USRPI, from a RIC characterized as a QIE, was also exempt from tax if the RIC shares were traded on an established securities market in the United States and the foreign investor held no more than 5% of the relevant stock or beneficial interests in the RIC during the year ending on the distribution date.

Investment through a domestically-controlled RIC allowed a foreign investor to avoid FIRPTA tax and related withholding on dispositions of RIC shares and also on RIC distributions attributable to USRPIs, if the investor held a minimal interest and the RIC was publicly traded in a U.S. market. The provision was scheduled to expire in 2009.

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[71] Section 897.

[72] Section 1445.

b. Two-Year Extension

Section 749 of the Tax Relief, Unemployment Reauthorization and Job Creation Act continues the favorable tax treatment under §897(h)(4)(A)(ii) for an additional two years. The benefit is now scheduled to expire for RIC taxable years beginning after December 31, 2011.[73]

16. Foreign-Targeted Bearer Bonds

In general, a taxpayer may deduct all interest paid or accrued within the taxable year on indebtedness. For registration-required obligations, a deduction for interest is allowed only if the obligation is in registered form. Generally, an obligation is treated as issued in registered form if the issuer or its agent maintains a registration of the identity of the owner of the obligation and the obligation can be transferred only through this registration system.[74]

In addition to the denial of an interest deduction, interest on a State or local bond that is a registration-required obligation will not qualify for the applicable tax exemption if the bond is not in registered form.[75] Also, an excise tax is imposed on the issuer of any registration required obligation that is not in registered form.[76] The excise tax is equal to one percent of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) during the period beginning on the date of issuance of the obligation and ending on the date of maturity. In addition, gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation is treated as ordinary income (rather than capital gain), unless the issuer of the obligation was subject to the excise tax described above.[77] Finally, deductions for losses realized by beneficial owners of registration-required obligations that are not in a registered form are disallowed.[78]

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[73] Section 749(a), Pub. L. 111-312.

[74] Section 163(a).

[75] Section 103(b)(3).

[76] Section 4701.

[77] Section 1287.

[78] Section 165(j).

A registration-required obligation is any obligation other than one that fits in one of four categories, which include, *inter alia*, a foreign targeted obligation.[79] A foreign targeted obligation is any obligation satisfying the following requirements:

i. There are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person;

ii. Interest is payable only outside the United States and its possessions; and

iii. The face of the obligation contains a statement that any United States person who holds this obligation will be subject to limitations under the U.S. income tax laws.[80]

Payments of U.S. source "fixed or determinable annual or periodical" income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30% rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[81] If however, the underlying debt instrument has the status of an item of portfolio indebtedness, the interest is exempt from U.S. income and withholding taxes for a foreign holder, and from estate tax if the foreign holder is an individual.[82]

The term portfolio interest means any interest (including original issue discount) that (a) is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person or (b) is paid on an obligation that is not in registered form and that meets the foreign targeting requirements of section 163(f)(2)(B) discussed above. Portfolio interest does not include interest received by a 10% shareholder,[83] certain contingent interest,[84] interest received by a

[79] Section 163(f)(2)(A).

[80] Section 163(f)(2)(B).

[81] Sections 871 and 881; Reg. §1.1441-1(b).

[82] Sections 871(h) and 881(c).

[83] Section 871(h)(3).

[84] Section 871(h)(4).

controlled foreign corporation from a related person,[85] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[86]

Under Title 31 of the United States Code, every "registration-required obligation" of the U.S. Treasury must be in registered form.[87] For this purpose, a registration-required obligation is any obligation except:

i. An obligation not of a type offered to the public;

ii. An obligation having a maturity (at issue) of not more than one year; or

iii. A foreign-targeted obligation .

Thus, a foreign-targeted obligation of the Treasury can be in bearer form rather than registered form.

b. Repeal of Exception for Foreign-Targeted Obligations

Section 502 of the HIRE Act repealed the exceptions to two adverse tax consequences for foreign-targeted obligations. Interest on such bonds will not be deductible nor will they qualify for the tax exemption granted to interest on State and local bonds. In addition, Section 502 repealed the treatment as portfolio interest for interest paid on bonds that meeting the foreign-targeting requirements discussed above. Now, interest qualifies as portfolio interest only if it is paid on an obligation that is issued in registered form and either the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a United States person or the I.R.S. determines that the statement is not required. For this purpose, a debt obligation held through a dematerialized book entry system or other book entry system specified by the I.R.S. is treated as held through a book entry system, provided that the debt obligation may be transferred only through that system. Finally, all foreign-targeted obligations of the U.S. Treasury must be in registered form.

The changes wrought by Section 502 are effective for bonds issued after March 18, 2012.

[85] Section 881(c)(3)(C).

[86] Section 881(c)(3)(A).

[87] 31 U.S.C. §3121(g)(3).

17. Foreign Tax Credit Splitters

a. Context

i. Direct foreign tax credits

Section 901 permits domestic corporations and U.S. resident individuals (collectively, "U.S. taxpayers") to claim a foreign tax credit ("FTC") for "income, war profits and excess profits taxes" ("foreign income taxes")[88] they pay directly to a foreign country or a U.S. possession.[89] In lieu of the credit, the taxpayer may deduct the foreign tax.[90]

ii. *Indirect, or "deemed-paid" foreign tax credits: §902*

Section 902 permits a domestic corporation that directly holds at least 10% of the voting stock of a foreign subsidiary to claim an FTC for foreign income taxes it is deemed to have paid or accrued at the time dividends are received from the subsidiary. Such a foreign subsidiary is termed a "Section 902 corporation." The amount of its creditable foreign taxes is a percentage of the foreign taxes it paid or accrued after 1986. This percentage is based on the ratio of the dividend to the subsidiary's undistributed post-1986 earnings and profits ("E&P").[91] Separate computations of earnings and taxes are required for undistributed E&P generated by a foreign subsidiary in a pre-1987 year.[92]

When such a subsidiary, in turn, receives a dividend from its own foreign subsidiary, it is deemed to pay the foreign income taxes imposed on its subsidiary's E&P, provided that it directly owns at least 10% and its U.S. parent indirectly owns at least 5% of the dividend-paying subsidiary's voting stock. Foreign taxes deemed paid by a first-tier subsidiary are calculated the same way as for taxes the U.S. corporation is deemed to have paid on a dividend received from that subsidiary.[93] This treatment also applies when a second-tier through sixth-tier foreign subsidiary, meeting the same ownership qualifications, receives a dividend from the foreign

[88] Section 901(b).

[89] Section 901(a), (b)(1). Substitutes, such as withholding taxes, are also eligible for credits. § 903.

[90] Sections 901(a), 163(a)(3).

[91] Section 902(a).

[92] Section 902(c)(6).

[93] Section 902(b)(1).

subsidiary at the next lower tier. Meeting such qualifications makes such lower-tier subsidiaries, along with the first-tier subsidiary, members of a "qualified group."[94] A subsidiary that is a "controlled foreign corporation" ("C.F.C.")[95] is subject to an exception if a "United States shareholder"("U.S. shareholder")[96] of the C.F.C. is a member of the group.[97]

Each qualified group member is also a "Section 902 corporation." Indirectly, the taxes deemed paid by lower-tier group members increase the foreign taxes deemed paid by the U.S. corporation.[98]

iii. Indirect or "deemed-paid" foreign taxes: §960

Section 960 generally permits a U.S. corporate shareholder of a Section 902 corporation that is also a C.F.C. to claim an indirect FTC for foreign income taxes on certain amounts it must include in income under Section 951(a). These amounts consist primarily of Subpart F income and inclusions required by Section 956 due to an increased investment in U.S. property,[99] both of which are treated as though they were dividend distributions to the U.S. corporation, even when the C.F.C. is a lower-tier subsidiary.[100]

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[94] Section 902(b)(2).

[95] A C.F.C. is generally a foreign corporation more than 50% of the vote or value of which is owned directly, indirectly or constructively by "U.S. shareholders" on any day during the corporation's tax year. Section 957(a).

[96] A "U.S. shareholder" is a U.S. person who owns or is treated as owning 10% or more of the voting stock of a foreign corporation. Section 951(b).

[97] Below the third tier, only such C.F.C. subsidiaries are included in the qualified group. In taxable years beginning after August 5, 1997, foreign taxes paid or accrued by any C.F.C. in the fourth, fifth or sixth tier are included.

[98] When any group member below the first tier pays a dividend that includes net income from other dividends it has received and on which it has paid foreign tax, a portion of those taxes are treated as paid by the recipient of the dividend. In such fashion, the U.S. corporation is ultimately treated as having paid some part of the dividends paid by lower-tier group members.

[99] Section 951(a)(1).

[100] Section 960(a)(1). This aspect of §960 is discussed in more detail below, in connection with new §960(c).

iv. Limitation

A U.S. taxpayer may only credit a limited amount of the potentially creditable FTCs it acquires each tax year in connection with foreign-source dividends and other inclusions. This limitation is calculated separately for passive income and general category income.[101] In each case, the FTC limit is a percentage of U.S. tax liability equal to the "basket's" ratio of foreign-source income within the basket to worldwide income. If the taxpayer's creditable foreign taxes exceed the limit, it may carry them back one year or forward ten years, provided that creditable foreign taxes for the earlier or later year do not absorb that year's limitation.[102]

v. The "Technical Taxpayer Rule"

The person treated as having paid or accrued a foreign tax – hence entitled to the FTC – is the person treated as legally liable for the tax under foreign law.[103] This is known as the "Technical Taxpayer Rule."

vi. Timing

The U.S. taxpayer may compute the FTC either under the cash method of accounting – when it is paid – or the accrual method of accounting – when it is properly accrued under U.S. tax accounting concepts, provided that the tax is actually paid within a specified period..[104] Once a taxpayer computing income under the cash method of accounting elects to use the accrual method to compute the FTC, the election is binding in future years.

Because of differences between U.S. and foreign law, a U.S. taxpayer may claim an FTC before it recognizes the foreign-source income giving rise to the credit. This may occur, for example, because of differences in characterization of entities or instruments or because of group relief provisions under foreign law. Consequently, FTCs may be claimed for income not recognized in a U.S. sense to offset U.S. tax on other foreign source income within the same basket that is subject to low rates of foreign tax. FTCs claimed prior to U.S. taxation of the related foreign source income

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[101] Section 904(d). As explained below in connection with new §904(d)(6), there is also a separate basket for certain income from U.S.-owned foreign corporations, as well as one for income from certain intangibles.

[102] Section 904(c).

[103] Reg. § 1.901-2(f)(1).

[104] A cash-basis U.S. taxpayer could take the FTC either in the year it is paid, or if it so elected under §905(a), in the year it accrued. An accrual-basis U.S. taxpayer could take the FTC in the year it accrued.

are viewed by the I.R.S. as abusive because the FTC does not serve the intended function of alleviating current double taxation.

vii. *Hybrid entity example*

An example of a perceived abuse involves hybrid entities formed outside the U.S. The parent of a foreign corporate group ("FP") is owned by a U.S. corporation ("USCo"). For U.S. tax purposes, FP is a disregarded entity; for foreign purposes, it is a corporation – thus, it has a hybrid nature for tax purposes, in that it is fiscally transparent under U.S. but not under foreign law. For foreign purposes, FP is also the person legally liable for the taxes imposed on all group members – *i.e.,* the "technical taxpayer." FP may be entitled to claim FTCs for income taxes it pays or accrues on behalf of the group prior to the time it recognizes income in the form of dividends from other group members.[105]

b. *Suspension of foreign tax credits*

Section 211 of the Education Jobs and Medicaid Assistance Act addresses the perceived abuse of claiming FTCs prior to recognizing income by enacting §909, which suspends the FTC until the income to which the foreign taxes relate is taken into account by a person subject to U.S. taxation. The trigger for suspending the FTC is a "foreign tax credit splitting event." An FTC splitting event occurs with respect to a foreign income tax "if the related income is (or will be) taken into account" for U.S. tax purposes "by a covered person."[106] This means that a splitting event occurs when the person who takes the income into account in the current period (the "covered person") is different from the person who pays or accrues the tax (the "payor"). A "covered person" is generally a person related to the payor of the tax. It is either an entity in which the payor holds at least a 10% direct or indirect ownership interest (by vote or value), any person who holds such an ownership interest in the payor, or any person related to the payor under concepts of §267(b) or §707(b).[107]

If a taxpayer pays or accrues any portion of a foreign tax, the FTC is suspended until the same taxpayer takes the income to which such portion relates (the "related

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[105] This was the case of *Guardian Industries Corp. v. Commr.,* 65 Fed. Cl. 50, 2005-1 U.S.T.C. ¶ 50, 263, *aff'd,* 477 F. 3d 1368 (Fed. Cir. 2007).

[106] Section 909(d)(1).

[107] Section 909(d)(4)(A)-(C). A covered person may also be any other person specified by the Treasury Secretary. Section 909(d)(4)(D).

income") into account for U.S. tax purposes.[108] If a Section 902 corporation pays or accrues any portion of a foreign tax, the FTC is suspended until the E&P on which the portion is levied is taken into account for U.S. income tax purposes by the same corporation or by a U.S. corporation that either owns 10% of its voting stock directly or 5% indirectly.[109] All such related income (including E&P) is determined under U.S. tax principles.

The I.R.S. has authority to issue "necessary or appropriate" guidance, including exceptions to §909 and rules for applying it to instruments treated as debt under U.S. law and equity under foreign law (or vice versa), *i.e.* hybrid instruments.[110]

Section 909 applies to foreign income taxes paid or accrued in tax years beginning after December 31, 2010. It also generally applies to foreign income taxes paid or accrued by a Section 902 corporation in tax years beginning in 2010 or earlier for purposes of determining indirect foreign tax credits after December 31, 2010.[111]

A hybrid instrument example may illustrate how §909 will work in the context of two C.F.C.s. A U. S. corporation ("USCo") wholly owns a C.F.C. ("C.F.C.1"), which wholly owns a C.F.C. engaged in an active business ("C.F.C.2"). Both are Country A corporations. C.F.C.2 issues a hybrid instrument to C.F.C.1 that is debt for foreign tax purposes, equity for U.S. tax purposes. C.F.C.2 accrues but does not pay $100 of interest to C.F.C.1. This accrued interest offsets C.F.C.2's $100 of active business income, leaving C.F.C.2 with no Country A income. C.F.C.1, however, has $100 of accrued (though unpaid) interest income, subject to $30 of Country A tax.

For U.S. tax purposes, C.F.C.2 takes into account $100 of E&P. (This amount is unreduced by $100 of interest, because the instrument is equity under U.S. tax law.)

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[108] Section 909(a), (d)(3). Here, a covered person, not subject to U.S. tax, would have had to take the income into account initially for a splitting event to have occurred.

[109] Section 909(b)(1), (d)(3). In addition, FTCs will not apply until such time for purposes of determining E&P under §964(a). Section 909(b)(2). Subsections (a) and (b) apply at the partner level in the case of a partnership. Similar rules will generally apply to S corporations and trusts. Section 909(c)(1).

[110] Section 909(e).

[111] Section 211(c), Pub. L. 111-226. Section 909 will not apply to foreign taxes paid or accrued by a Section 902 corporation in order to determine E&P under §964(a). *Id.* IRS and Treasury have provided initial guidance concerning pre-2011 splits between taxes and related and other matters. Notice 2010-92.

This $100 of C.F.C.2 E&P is treated as the related income with respect to which C.F.C.1 has paid $30 of foreign income tax. Since C.F.C.1, the payor, owns at least 10% of the voting stock of C.F.C.2, C.F.C.2 is a covered person. Accordingly, there has been a splitter event.

C.F.C.1, the payor, is a Section 902 corporation. Therefore FTCs for all or part of the $30 of C.F.C.1 tax C.F.C.1 paid will not be available until C.F.C.1 or USCo take all or part of the $100 of C.F.C.2 "related income" into account for U.S. tax purposes. If C.F.C.2 never pays C.F.C.1 even a partial dividend out of this amount, because it has no E&P available to support a dividend under Country A law, the FTCs may never come out of suspension and be available.[112]

18. Covered Asset Acquisitions

a. *Context*

The operation of Section 902, which permits indirect, or "deemed-paid", foreign tax credits ("FTCs"), has been previously described. The limitation on FTCs based on the taxpayer's U.S. tax liability for foreign source income is also described above. Here, another aspect of FTCs is at issue: their interaction with basis step-ups under U.S. but not under foreign law.

Three provisions of U.S. tax law result in permanent differences in the depreciable cost bases of assets for U.S. and foreign tax purposes. These provisions are (a) §338 elections in the context of stock acquisitions, (b) §754 elections in the context of acquisitions of partnerships and hybrid entities, and (c) "check-the-box" elections for foreign eligible business entities already owned. All three are viewed in the context of a transaction involving an acquisition or disposition of a foreign entity or a U.S. entity with foreign assets.

i. *Section 338 elections*

Taxpayers may elect under §338 to treat a purchase of 80% of the stock of a target corporation (measured both by vote and value) by another corporation, completed within a 12-month acquisition period (a "qualified stock purchase"), as a purchase of the target's assets.[113] The target is treated as having sold all of its assets at the

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[112] This example is drawn from the §909 legislative history. 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 Representatives on August 10, 2010* (JCX-46-10), August 10, 2010, @ 6, available at www.jct.gov. ("JCX-46-10").

[113] Section 338(a), (d)(3).

end of the acquisition date and, as a new corporation, purchased the assets the next day. The assets are treated as purchased for an amount equal to the grossed-up basis of the acquirer's recently purchased stock and the basis of its nonrecently purchased stock.[114] Taxpayers electing under §338 do so, in part, to achieve a stepped-up basis in the underlying operating assets, so as to minimize income from increased costs attached to the assets – i.e., a step-up in inventory value and depreciable basis in fixed assets – and to minimize income or gain on future asset sales – i.e., from the sale of inventory or a manufacturing plant.

Section 338 provides for two alternatives in connection with the gain that must be recognized at the time the election is made. If a corporation purchases a domestic target in this fashion and the target is either a consolidated or affiliated group member or an S corporation and both the purchaser and the selling group (or selling S shareholders) make an election under Section 338(h)(10), the target is deemed to be liquidated before it is acquired.[115] This means that the seller has the income generating event. For the holder of an S corporation or for a group with a net operating loss, the tax cost may not be viewed to be significant. On the other hand, a purchasing corporation may elect to treat a stock acquisition of either a domestic or a foreign corporation from any seller(s) as an asset purchase by electing under §338(g). The seller(s) will then recognize gain or loss on the stock sale (unless, generally, they are foreign persons) and the target will recognize gain or loss on the purchase of its assets. The target recognizes the gain after the stock sale has occurred, and in effect, the purchaser bears the tax cost. In the international context where §338 does not exist in the foreign country, the purchaser has no interest one way or the other as to which election should be made and so the election under §338(h)(10) is not generally a deal point in the negotiations.

ii. *Section 754 elections*

If a partnership has a Section 754 election in place when an interest in the partnership is transferred, the basis of the partnership's property will be stepped-up with respect to the transferee partner as a result of any premium paid for the partnership interest.[116] Where the partnership holds foreign income-producing assets, a U.S. transferee partner may, as a result, recognize less taxable income for U.S. tax purposes than it recognizes for foreign tax purposes. The step-up in assets may be attributable to inventory that turns over several times during a year or depreciable assets. By increasing the adjusted cost basis for those assets, the acquiring partner will realize less taxable income from operations.

[114] Section 338(b).

[115] Reg. § 1.338(h)(10)-1(d)(3).

[116] Section 754, 743(a), (b).

iii. *Check-the-box elections*

A "check-the-box" election permits a taxpayer to change the characterization of an entity for U.S. tax purposes.[117] A foreign corporation wholly owned by a U.S. corporation, for example, may be treated as a disregarded entity if it is an eligible entity and an election is made. The election to be treated as a disregarded entity or as a partnership is treated as a liquidation for U.S. tax purposes.[118] If 80% or more of the foreign corporation is owned by a single U.S. shareholder, the liquidation will not result in a step-up in the basis of assets except to the extent of the interest of another shareholder.[119] On the other hand if two or more domestic members of a group own the foreign eligible entity and no single member owns as much as 80% of the foreign entity, gain will be recognized as a result of the election and a step-up in the basis of the assets will occur for income tax purposes.[120] Once the basis in the assets is stepped up for U.S. income tax purposes, the operations may be reported on a U.S. tax return as marginally profitable even if the taxable profits are substantial for foreign tax purposes.

As the foregoing discussion indicates, differences between U.S. and foreign tax law can lead to distortions that magnify the effective rate of foreign tax when income is measured by U.S. standards. The excess foreign tax can give rise to an FTC that offsets low tax foreign source income within the same FTC limitation basket. Typically, that low tax income takes the form of license fees and interest received from a related C.F.C. Such fees and interest would be treated as general basket income in the hands of the U.S. group if and to the extent they reduce foreign tax on operating income.[121]

b. *Denial of FTC for Covered Asset Acquisitions*

Section 212 of the Education Jobs and Medicaid Assistance Act, enacted §901(m), which is designed to eliminate FTCs that, as a result of U.S. basis step-ups, exceed the amount necessary to offset U.S. tax. It does so by requiring that FTCs connected with "covered asset acquisitions" be determined without reference to the "disqualified portion" of the associated foreign tax.[122] A covered asset acquisition is

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[117] Reg. §301.7701-3.

[118] Reg. §301.7701-3(g)(1)(ii) and (iii).

[119] Sections 337 and 334(b)(1).

[120] Section 336 and 334(a).

[121] Section 904(d)(3).

[122] Section 901(m)(1).

a qualified stock purchase as to which a §338 election is in effect, an acquisition of an interest in a partnership with a §754 election in effect, or "any other similar transaction" to the extent provided by the I.R.S.[123]

The disqualified portion of an associated foreign tax is calculated by reference to aggregate basis differences among relevant foreign assets. A relevant foreign asset, including an intangible such as goodwill, is any foreign asset with respect to (*i.e.,* acquired in) a covered asset acquisition, if income, deduction, gain or loss attributable to it enters into determination of the foreign income tax related to the acquisition.[124] The basis difference with respect to any such asset is generally the excess of its adjusted basis immediately after the covered asset acquisition over its adjusted basis immediately before the acquisition.[125] These basis differences are aggregated for purposes of determining the disqualified portion of the foreign tax, and the amount allocable to the current tax year[126] is divided by the income or gain on the relevant foreign assets that is used to calculate the foreign income tax for the year. The percentage of such foreign tax (derived from this ratio) is the disqualified portion.[127]

Section 901(m) applies generally to covered asset acquisitions after December 31, 2011, unless the transferor and transferee are unrelated and have made certain arrangements to proceed with the acquisition prior to such date.[128]

To illustrate the application of the provision, assume that a U.S. corporation ("USCo") acquires 100% of the stock of a foreign target ("FT"), in a qualified stock purchase with a §338(h)(10) election in effect. The aggregate basis difference in connection with the acquisition is $200, consisting of $150 attributable to an asset with a 15-year recovery period (hence, $10 of annual amortization) and $50 from an asset with a 5-year recovery period (therefore, $10 of annual depreciation). In year 1, FT has $100 of foreign taxable income from relevant foreign assets and pays $25 of foreign tax. The basis difference allocable to year 1 is $20 ($10 each of

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[123] Section 901(m)(2).

[124] Section 901(m)(4).

[125] Section 901(m)(3)(c)(i).

[126] Section 901(m)(3)(B). The basis difference with respect to any relevant foreign asset is allocated according to the cost recovery method applicable to such asset under the Code. Any basis difference remaining upon disposition of the asset is allocated to the year of disposition.

[127] Section 901(m)(3)(A).

[128] Section 212(b), Pub. L. 111-226.

amortization and depreciation). This basis difference of $20 is divided by the $100 of foreign taxable income and yields a ratio of 1:5, or 20%. Thus, the disqualified portion of the $25 foreign tax (20%) is $5 – the amount that may not be used to calculate FTCs.[129]

19. FTC Limitation for Income Resourced Under Treaties

a. *Context*

The separate §904(d)(1) baskets for passive and general income prevent "cross-crediting," the phrase used to describe the use of FTCs generated by active foreign source business income to reduce U.S. tax on foreign source passive income. Two other separate baskets prevent the cross-crediting of FTCs attributable to an item of income treated as foreign-source pursuant to a treaty rule applied at the taxpayer's option, when the treaty rule overrides U.S. domestic law that would otherwise treat the item as U.S. source income.

One such basket is for certain interest, dividends, and Subpart F[130] and P.F.I.C. [131] inclusions received from a U.S.-owned foreign corporation. Under a special rule in §904(h) that is applicable in the absence of a treaty, those items can be treated as domestic source income when the income from the foreign entity is considered to be U.S. source income. In other words, for purposes of computing the FTC limitation, domestic income cannot be turned into foreign source income merely because the income is recognized by a U.S.-owned corporation.,[132] The Code resources such income as arising from U.S. sources, to prevent U.S. taxpayers from inflating the FTC limitations by arranging to earn U.S. income through foreign affiliates that pay little tax in their country of residence.[133] When taxpayers sidestep this resourcing rule by electing a contrary treaty source rule, the separate basket prevents this low-tax income from absorbing excess FTCs attributable to other income.

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[129] This example is drawn from the legislative history. *See* JCX-46-10 @ 15.

[130] Subpart F requires U.S. shareholders of C.F.C.s to include currently both "Subpart F income," discussed separately below, and increased investments in U.S. property defined in §956. Section 951(a).

[131] If 75% of the income of a foreign corporation is passive or 50% of its assets during the taxable year produce or are held to produce passive income, the corporation is a P.F.I.C. Section 1297(a).

[132] Section 904(h)(1).

[133] JCS-46-10 @19.

The other separate basket is for gains from the sale of stock in a foreign corporation, the sale of certain intangibles, and liquidating distributions from certain U.S. possessions corporations.[134] These, too, are subject to a separate FTC limitation when taxpayers elect a treaty foreign-source rule in lieu of the Code's treatment of such gains as U.S.-source income.

b. Mandatory Resourcing of Income

Section 213 the Education Jobs and Medicaid Assistance Act enacted §904(d)(6), which creates a separate FTC limitation for income treated as U.S.-source under the Code, but is resourced by treaty. The new rule will not apply to electively resourced items already subject to separate FTC limitations. In effect, the provision extends separate basket treatment of income resourced as foreign income pursuant to a treaty to all such income. Treasury may aggregate related items of income,[135] including those from the same trade or business.

20. Foreign Taxes Deemed Paid When §956 Applies

a. Context

As explained above in connection with new §909, §§902 and 960 both enable a U.S. corporation to claim deemed-paid FTCs for foreign taxes paid by certain foreign subsidiaries. Such foreign subsidiaries, termed Section 902 corporations, are treated as members of a qualified group with the ability to generate such deemed-paid foreign taxes. The amount of deemed-paid foreign taxes potentially creditable by a U.S. corporation is determined for both sections under the §902 formula: in general, post-1986 deemed-paid foreign taxes x (dividend or inclusion amount/ undistributed post-1986 E&P).

Such deemed-paid taxes are amassed differently, however, under the two sections. Only foreign taxes paid by a first-tier corporation in connection with a dividend paid to the U.S. corporation are deemed to have been paid by the U.S. corporation under §902. Foreign taxes paid by a lower-tier subsidiary are treated as paid by the foreign corporation in the next tier up, when it receives a dividend from the lower-tier subsidiary. In this fashion, at least some part of the foreign taxes paid by lower-tier subsidiaries travels up the chain to the U.S. corporation.

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[134] Section 865(h). The affected intangibles are patents, copyrights, secret processes or formulas, goodwill, trademarks, trade brands, franchises and "other like property." Section 865(d)(2) and (h)(2).

[135] Section 904(d)(6)(C).

By contrast, §960 treats inclusions of Subpart F income and increased investments in U.S. property under §956 as deemed dividends paid directly to a U.S. corporation, even if attributable to a lower-tier C.F.C. within the qualified group. Because the rule allows a §960 inclusion to bypass all subsidiaries between the one whose Subpart F income or Section 956 investment creates the inclusion and the U.S. corporation, the rule is known as the "hopscotch rule."

The computational difference between the chain method and the hopscotch method affects the amount of foreign taxes that become available to the U.S. corporation for purposes of determining its FTC. In circumstances where a first-tier C.F.C. foreign subsidiary incurs relatively little tax and a lower-tier C.F.C. foreign subsidiary operates in a high-tax jurisdiction, §960 is a valuable tool to bring high-taxed income into the U.S. tax return without dilution at an intervening level. If dividends were simply distributed up the corporate chain, the effective tax rate attached to the dividend could be diluted at each intervening level.

Congress believed that U.S. corporations were using the hopscotch rule to generate extra FTCs from high-tax jurisdictions through loans and other §956 income inclusions to manage the foreign tax credit. For Congress, managing tax liabilities is viewed to be an abusive practice.

b. Elimination of Hopscotch Rule

Section 214 of the Education Jobs and Medicaid Assistance Act enacted §960(c), which limits the amount of foreign taxes deemed paid by a U.S. corporation in connection with the inclusion of a C.F.C.'s increased investment in U.S. property. The limitation is the amount that would have been deemed paid if cash in the amount of the inclusion had been distributed up through the chain of ownership. This amount is termed the hypothetical credit, in contrast to the tentative credit that results from application of §960 without regard to the new provision.[136] Existing rules for determining FTCs apply to calculation of the hypothetical credit, except that foreign income and withholding taxes that would apply to actual distributions are ignored. Otherwise, they could result in increases in the FTC. In any event, they are not paid until actual distributions are made. The §960(c) limitation applies to deductions as well as to credits for foreign taxes.

The provision is effective for acquisitions of U.S. property as defined in §956(c) after December 31, 2010. The hopscotch rule continues to apply under §960 to inclusions of Subpart F income.

An example illustrates how the provision will work. Assume that a second-tier Country B foreign subsidiary ("C.F.C.2"), wholly owned by a Country A first-tier subsidiary ("C.F.C.1"), makes a $100 loan to a U.S. corporation ("USCo") that is the

[136] JCX-46-10 @ 24.

sole owner of C.F.C.1. This amount represents an increased investment in U.S. property under §956.

C.F.C.2's post-1986 foreign income taxes are $50 and its post-1986 undistributed earnings are $100. Therefore, USCo's tentative credit (calculated without regard to Section 960(c)) is $50. This amount represents: (C.F.C.2's deemed-paid dividend to USCo ($100)/C.F.C.2's post-1986 undistributed E&P ($100)) x C.F.C.2's post-1986 foreign taxes ($50).

USCo's hypothetical credit is based, first, on a hypothetical distribution of $100 in cash by C.F.C.2 to C.F.C.1. Country B's 10% withholding tax on the distribution is ignored. The distribution increases C.F.C.1's prior post-1986 E&P from $200 to $300. It also increases C.F.C.1's prior post-1986 foreign income taxes from $10 to $60, since C.F.C.1 is deemed by Section 902 to have paid the $50 of tax actually paid by C.F.C.2. Next, there is a second hypothetical distribution of the same $100 from C.F.C.1 to USCo. USCo will be deemed to have paid the amount of foreign taxes paid by C.F.C.1, *i.e.* $20. The calculation of C.F.C.1's deemed $20 payment is as follows: (C.F.C.1's deemed-paid dividend to USCo ($100)/ C.F.C.1's post-1986 E&P ($300)) x C.F.C.1's post-1986 foreign taxes ($60).

This $20 is USCo's hypothetical credit. Because its hypothetical credit is less than its tentative credit, it is limited to the hypothetical credit.

21. Section 304(b)(5)(B) and Redemptions by Foreign Subsidiaries

a. Context

Section 304 concerns two kinds of stock redemptions by related corporations: §304(a)(1) "brother-sister" or "cross-chain" acquisitions by one corporation (the "acquirer") of a commonly controlled corporation (the "target") other than its parent and §304(a)(2) "parent-subsidiary" acquisitions, in which a subsidiary acquires the stock of a controlling corporation. In both cases, the target's stock is acquired from a target shareholder (the "transferor") in exchange for money or other property and the transaction is treated as a redemption. In a parent-subsidiary context, the transaction is considered a redemption of the parent's (the target's) stock; in a brother-sister acquisition, a redemption of the acquiring corporation's stock.

A redemption may be treated either as a §302(b) exchange or as a §301 dividend distribution. When dividend treatment applies, §304(a)(1) creates a two-part fiction: (1) the transferor is treated as transferring the target's stock to the acquirer in exchange for stock of the acquirer in a §351(a) transaction, and (2) the acquirer is then treated as redeeming the stock it issued.

For purposes of determining the amount and source of the dividend distributions arising from the transferred property, §304 treats the distribution as exhausting first the acquirer's and then the target's E&P.[137] Any portion of a distribution from the acquirer's E&P is treated as a direct distribution from the acquirer to the transferor.[138] As we saw with §956 inclusions, this amounts to a "hopscotch rule", which prevents the distribution from passing through intervening corporations in the chain of control.

If the acquirer is foreign, its E&P may be used only it is a C.F.C. and the E&P is attributable to stock held by one or more of its U.S. shareholders (or persons related to its U.S. shareholders) while the corporation was a C.F.C. and the E&P was accumulated.[139] If a foreign shareholder of a U.S. target is the transferor and the target's E&P is the source of the dividend distribution, a 30% U.S. withholding tax generally applies, unless a treaty provides full or partial relief.[140] If the target and the transferor are both foreign – which would exist when a foreign corporation acquires a U.S.-based multinational group – the hopscotch rule prevents the distribution from passing through any intervening U.S. corporations on its way to the foreign transferor. Thus, no U.S. tax applies to the distribution regardless of whether it is sourced from the C.F.C.'s or the target's E&P. At the same time, because the C.F.C.'s E&P is reduced when it is the source of the distribution, the potential for U.S. taxation of its U.S. shareholders' Subpart F income and §956 inclusions is also reduced.

Congress perceived a C.F.C.'s §304 acquisitions from foreign shareholders of the target as a vehicle for draining C.F.C. E&P with no significant U.S. tax consequences, unless most of the distribution was sourced from the E&P of a U.S. target.

b. Modifications to E&P Sourcing Rule

Section 215 of the Education Jobs and Medicaid Assistance Act enacted §304(b)(5)(B), which blocks the use of a C.F.C.'s E&P as a source for §304(a) dividend distributions unless more than 50% of the dividends arising from the acquisition (determined without regard to the new provision) are subject to U.S. tax in the year the dividend arises or includible in the C.F.C.'s E&P. The provision is effective for acquisitions after August 10, 2010.[141] In effect, it means that foreign

[137] Section 304(b)(2).

[138] *E.g.,* Rev. Rul. 80-189, 1980-2 C.B. 106.

[139] Section 304(b)(5).

[140] Section 1442(a).

[141] Section 215(b), Pub. L. 111-226.

shareholders may transfer only stock of U.S. corporations to C.F.C.s in §304 redemptions subject to §301, unless the C.F.C.'s E&P supports less than 50% of the property distribution.

22. Subpart F Exceptions for Active Financing Income

a. *Context*

The most significant inclusions in "Subpart F income" are "insurance income" and "foreign base company income."[142] Passive income such as dividends, interest, royalties, rents, annuities, net gains from sales of or transactions involving certain investment properties, and amounts received under certain personal service contracts comprise a category of foreign base company income called "foreign personal holding company income"("FPHCI").[143] Other categories include foreign base company income from sales and services.[144] For Subpart F purposes, "insurance income" means C.F.C. income attributable to insurance of risks outside the C.F.C.'s country of organization, whether directly through contracts issued by the C.F.C. or indirectly through arrangements with another company.[145] Subpart F income does not include any ECI, which as mentioned above, is income effectively connected to a U.S. trade or business,[146] or income in excess of a C.F.C.'s current-year E&P.[147]

Exceptions to Subpart F income apply to income derived in the ordinary course of certain businesses. One such exception applies to foreign base company services income from marketing or pre-sale services performed in connection with sales of property manufactured, produced, grown or extracted by the C.F.C.[148] Other exemptions from Subpart F services income apply to insurance income exempt from Subpart F generally or from FPHCI, as active financing income.[149]

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[142] Section 952(a)(1), (2).

[143] Section 954(c).

[144] Section 954(a)(2),(3).

[145] Sections 953(a), (e)(7)(A); §954(h)(7)(C) Prop. Reg. § 1.953-1(a).

[146] Section 952(b).

[147] Section 952(c).

[148] Section 954(e)(2).

[149] *Id.* (last sentence).

Certain income of a C.F.C. predominantly engaged in the active conduct of banking, financing or similar business is excluded from FPHCI categorization if the C.F.C. conducts substantial activity in connection with such business. The exempt income includes income the C.F.C. earns from customer transactions outside the United States if the C.F.C. directly conducts substantially all activities in connection with such transactions in the country under the laws of which it was established. Similar income of a "qualified business unit" ("QBU") of the C.F.C. is exempt from FPHCI under similar conditions.[150]

Interest and dividends (or certain equivalents) earned by a securities dealer are also exempt from FPHCI if earned by a securities dealer in the ordinary course of the dealer's trade or business. Income earned through a dealer's QBU qualified if it is attributable to the dealer's activities in the dealer's home country or to QBU activities in the country where the QBU maintains its principal office and conducts substantial business activity.[151]

In addition, an exemption from both FPHCI and from insurance income applies to investment income of certain C.F.C. insurance companies and their branches when such income is allocable to contracts exempt from FPHCI.[152]

Active financing income exceptions to Subpart F, first enacted in 1997, have been extended repeatedly since. The prior exceptions were scheduled to expire at the end of 2009.[153]

Active business income is not within the scope of Subpart F. Neither is income connected to the financing of a C.F.C.'s active foreign business. Congress has therefore repeatedly exempted such financing income from current inclusion in the income of a C.F.C.

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[150] Section 954(h).

[151] Section 954(c)(2)(C)(ii).

[152] Section 954(i).

[153] Sections 953(e)(10), 954(h)(9).

b. Extension of Exceptions

Section 750 of the Tax Relief, Unemployment Reauthorization and Job Creation Act extended the prior temporary exceptions for active financing income for two years. The exceptions now apply to tax years of C.F.C.s beginning before 2012 and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.[154]

23. Look-Thru Treatment Of Payments Between Related C.F.C.s

a. Context

Certain passive income with a connection to the country where a C.F.C. is organized is not treated as foreign personal holding income ("FPHCI") when received by a C.F.C. from a related corporation. Dividends and interest are generally excepted when the related corporation is organized and operates in such country. Rents and royalties are generally excepted when paid for use of property in that country. Related-corporation payments of dividends, interest, rents and royalties that lack the connection to the C.F.C.'s country of organization do not qualify for the exception.

As noted earlier, Subpart F income, including FPHCI, generally does not include ECI, income effectively connected with a U.S. trade or business. This exclusion does not include income relieved of U.S. taxation or subject to a reduced rate under a treaty.[155] Treaty-benefited ECI consisting of dividends, interest, rents or royalties will therefore be Subpart F income when received from a related person.

However, if the related corporation from which the C.F.C. receives a payment of dividends, interest, rents or royalties is another C.F.C., relief may be available even if the payment does not qualify for the related-corporation exception or the ECI exclusion. Under a look-thru rule for related C.F.C.s, such payments will generally escape FPHCI characterization if they are attributable to income of the payor C.F.C.

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[154] Section 750, Pub. L. 111-312.

[155] Section 952(c).

that is neither Subpart F income or ECI.[156] This look-thru rule was scheduled to expire at the end of 2009.[157]

b. Extension of Look-Thru Rule

Section 751 of the Tax Relief, Unemployment Reauthorization and Job Creation Act extended the look-through rule for two years. It now applies to taxable years of foreign corporations beginning before 2012 and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

24. Conclusion

The year 2010 was a banner year for changes in the provisions of U.S. tax law that apply to cross border transactions. Many sophisticated plans were attacked in the legislation and Congress asserted its right to control the borders of the U.S. and to protect the tax base. The question many advisers now ask is whether 2010 was merely the prologue to additional changes in the near future.

[156] Section 954(c)(6)(A). The look-thru rule will not apply if the payment consists of interest, rents or royalties and it creates an E&P deficit that reduces the payor's Subpart F income. Section954(c)(6)(B). Note that an identical exception applies to the related-corporation payment exception from FPHCI. §954(c)(3)(B). Thus, the look-thru rule will not cure any failure to qualify under the related-corporation exception, when the failure is caused by a resulting payor E&P deficit.

[157] Section 954(c)(6)(C).