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M E M O R A N D U M

TO: Clients & Friends of the Firm

FROM: The Ruchelman Law Firm[*]

RE: Overview of the Principal Provisions of Jobs Act

DATE: December 9, 2004

We are pleased to provide this overview of the international tax provisions of the American Jobs Creation Act of 2004 (the Act) signed by the President and entered into force on October 22, 2004. Many comments have been made regarding provisions of the Act, noting both technical provisions and open issues. We trust this overview provides insight into the thought process that can be employed by U.S.-based multinational corporations and foreign investors in the U.S. in prioritizing strategies to deal with the Act's provisions.

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I. Response to Inversions and ETI Ruling

A. Inversion Transactions

Section 801 of the Act adds new Code Section 7874, which contains rules relating to expatriated entities and their foreign parents. The legislative history of the provision indicates clearly that the intent of Section 7874 of the Code is to address perceived tax abuses resulting from the high profile

inversion transactions undertaken by major publicly listed U.S. multinational corporations. These inversion transactions involved the transfer outside the U.S. of stock or assets as part of a business restructuring designed to remove business operations from U.S. taxation jurisdiction.

Section 7874 of the Code provides that if an inversion transaction meets the criteria set forth therein, the inverted corporation will have to report as a minimum the amount of "inversion gain." The key definitions for application of Section 7874 are "surrogate foreign corporation," "expatriated entities" and "inversion gain." These terms are relevant to the extent an "inversion transaction" has occurred.

An inversion transaction means a plan in which the owners of a domestic entity become the owners of a defined percentage of a foreign incorporated entity. The key aspect of an inversion plan is the establishment of a "surrogate foreign corporation" as that term is defined in new Code Section 7874(a)(2)(B). That provision states, in relevant part, that "surrogate foreign corporation" status is established where the inversion plan results in the acquisition of 60% or 80% of a domestic entity depending on the nature of the transaction, by a foreign incorporated entity. When this happens, the domestic corporation is considered an expatriated entity held by a surrogate foreign corporation. The domestic entity, whether a corporation or partnership, is subject to reporting and taxation of the "inversion gain."

The application of new Section 7874 is a mechanical process driven by its overriding concern with the high profile inversion transactions, For example, where a domestic entity is held indirectly by nonresident individuals through a U.S. passthrough entity, and that passthrough entity distributes stock in the domestic entity to the nonresident individuals in a liquidating distribution, Section 7874 will not apply. No foreign incorporated entity will acquire the stock or interest in a U.S. domestic entity in this case. Hence, no surrogate corporation status will be established. It follows that the domestic entity will not be considered to be an expatriated entity subject to inversion gain reporting and taxation. Support for this conclusion is found in the fact that for U.S. tax purposes there has been no erosion of the tax base and no transfer of taxable business operations outside the purview of the U. S. tax system, business activities will be taxed in the same manner from a U.S. tax perspective subsequent to the transaction.

Section 7874 is effective for taxable years ending after March 4, 2003. The key concern in consideration of its effect on a U.S. multinational group is whether the provision inadvertently applies to legitimate internal restructurings of the international group or bona fide business deals. Section 7874's "substantial business activities" test may be intended to address this issue. Under this test the acquisition of a domestic entity considered the inverted corporation acquired by the surrogate foreign corporation is subject to inversion gain only if the expanded affiliated group (including the surrogate foreign corporation) does not have substantial business activities relative to total business activities in the country of incorporation of the surrogate foreign corporation. Thus, an acquisition made through an established tax paying substantive surrogate foreign corporation would presumably not run afoul of Section 7874. In addition Section 7874(c)(2) provides that the threshold 60% or 80% stock ownership determination of Section 7874 will be made without regard to stock already held by members of the expanded affiliated group including the surrogate foreign

corporation. This should allow for transfers of legal entities within an already existing multinational legal structure and not trap, for example, legitimate Section 304 planning transactions.

All in, the inversion provision of the Act seems to be limited to insuring a minimum tax on high profile transactions where the U.S. tax base could suffer permanent erosion.

B. Repeal of ETI/Allowance of Rate Reduction for Qualified Production Activities Income

The relevant provisions of the newly enacted tax legislation repeal the existing exclusion from U.S. tax of extraterritorial taxable income (ETI) and replace that regime with a corporate tax rate reduction for “qualified production activities income” (QPAI). These two provisions and their relation with the areas of transfer pricing and foreign tax credit planning present significant tax planning issues and opportunities for taxpayers.

The repeal of ETI was mandated by the World Trade Organization which deemed this tax regime an illegal trade incentive on export sales activities on the part of the United States. The effective tax rate reduction of 5.25% on taxable income from qualifying export sales is thus being phased out over the 2005 and 2006 two-year period. The ETI benefit for 2005 is 80% of the full benefit under the ETI regime and 60% of that benefit for 2006. Full ETI benefits will continue for export sales made under binding contracts with customers that were in existence on or before September 17, 2003, but otherwise the ETI benefit will no longer exist after 2006.

To ease the anticipated tax burden from the ETI repeal in a way that encourages the expansion of U.S. based manufacturing operations, a Federal tax rate reduction for QPAI will be phased in over a multi-year period. The rate reduction is effected by allowing a deduction equal to the lesser of QPAI or taxable income. The deduction will be equal to 3% of the appropriate amount in 2005-2006; 6% in 2007-2009 and 9% thereafter. Thus the full phased in deduction will result in a tax rate of 31.85% (91% of 35%) on the lesser of overall taxable income or QPAI.

It is possible to have taxable income which is not QPAI and thus not entitled to the lower tax rate. This is because the definition of QPAI keys into U.S. manufacturing activities and income earned therefrom as those terms are or will be defined. U.S. manufacturing activities as initially defined do not include certain kinds of income such as income from distribution activities. Open issues exist regarding the final definition of manufacturing activities, that is, will they reference the substantial transformation criteria of the Subpart F regime, do they include contract manufacturing, etc. Income from U.S. manufacturing activities will also need further clarification. The Act refers to QPAI as domestic production gross receipts less directly allocable cost of goods sold directly allocable to the domestic production gross receipts less other costs directly allocable and a ratable portion of costs not directly allocable. Conference reports on this provision of the Act indicate that the determination of expenses in these two latter categories could be made by reference to allocation and apportionment principles of Section 861 for determining foreign source taxable income.

The phased in repeal of ETI and the deduction for QPAI leave taxpayers at a crossroads even assuming clarification of the technical uncertainties noted. The key crossroad issues can be stated as:

- Can a company claim both ETI and QPAI benefits during the phase in periods?
- Does the U.S. become a low or lower tax jurisdiction within the multinational tax and legal entity structure? Does this affect transfer pricing policies and procedures?
- Will allocations away from foreign source income to maximize QPAI be inconsistent with existing foreign tax credit planning positions?

1. Duplication of ETI and QPAI Benefits

There is nothing specific indicating that these two benefits are mutually exclusive. Taxpayers who would otherwise qualify will seek to maximize their ETI benefit for 2005 and 2006. Maximization of ETI benefit might also be consistent with maximization of QPAI to the extent the export sales qualifying for ETI is from U.S. manufacturing activities. For example, in 2005, a given item of taxable income could be subject to an effective tax rate reduction of 4.2% (80% of the 5.25% ETI benefit) plus 1.05% (3% QPAI tax reduction off of the 35% corporate rate) or the same 5.25% full ETI benefit. In 2006, the effective tax rate reduction would be 3.15% (60% of the 5.25% ETI benefit) plus the 1.05% QPAI reduction for a 4.20% benefit, or 80% of the full ETI benefit. The interplay of the combined effective tax rate reductions, as compared with the stand-alone ETI effective tax rate reduction, indicates an acknowledgment that ETI and QPAI tax benefits can be taken together where possible.

2. The U.S. as a Low Tax Jurisdiction

The combination of ETI and QPAI in 2005 and 2006 and the completion of the full QPAI tax reduction thereafter could position the United States as a lower or, on an absolute basis, a low tax jurisdiction for the U.S. multinational corporation. Thus, tax rate arbitrage planning through transfer pricing may have to be reexamined in conjunction with increasing U.S. manufacturing capabilities. U.S. multinationals would be well served to reexamine their transfer pricing policies and procedures to address changes in internal functions and risks assumed in the U.S.

3. QPAI and Foreign Tax Credit Planning

Foreign tax credit planning under prior tax law emphasized maximization of foreign source taxable income, which was the basis for computing allowable foreign tax credits. While the law provided a two-year carryback and five year carryforward period, this did not guarantee full utilization of foreign tax credits generated. The various foreign tax credit baskets and the need to allocate and apportion deductions under the rules of Section 861 and the regulations issued thereunder presented serious impediments to full utilization of foreign tax credits.

New tax law now emphasizes the generation of U.S. source manufacturing income rather than foreign source taxable income. Allocation of deductions pursuant to Section 861 principles to determine QPAI will directly conflict with legacy foreign tax credit planning positions. Simplification of the foreign tax credit area under the new tax law may ameliorate this issue. The foreign tax credit carryforward period has been extended to ten years from five years (with a one-year carryback) effective from the enactment date of the new law and the foreign tax credit baskets have been reduced to two effective for taxable years beginning after December 31, 2006. These foreign tax credit provisions come with detailed transition rules but, all in, are designed to give some relief to the U.S. multinational's excess foreign tax credit position. However, planning to optimize QPAI will entail allocation of expenses to foreign source income. From a foreign tax credit planning perspective, this could offset a significant portion of the benefit of the foreign tax credit provisions. On the other hand U.S. multinationals may be entitled to both benefits if there is a proper balance between maximizing QPAI and foreign tax credit utilization.

C. Aircraft Leasing and Shipping Income under Subpart F

There is a close relationship between provisions relating to U.S. international aircraft leasing and shipping operations and the ETI repeal. Leasing operations had taken advantage of the repealed ETI regime. As a consequence of its repeal, Congress sought to provide some type of relief to the industry.

Under current law, one form of income of a controlled foreign corporation ("C.F.C.") that is taxable to U.S. Shareholders under Subpart F is Foreign Base Company Shipping Income. Foreign Base Company Shipping Income generally includes income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (e.g., leasing of satellites for use in space). Also taxed under Subpart F is Foreign Personal Holding Company Income, which generally includes rental income unless an active rental business is carried on by the C.F.C.

The Jobs Act repeals the Subpart F rules relating to Foreign Base Company Shipping Income. It also amends the exception from Foreign Personal Holding Company Income applicable to rents or royalties derived from unrelated persons in an active trade or business by providing a safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce. The exclusion applies if the active leasing expenses to 10% or more of the profit on the lease. Principles similar to those of existing regulations issued under Code §954(c)(2)(A) are to be applied. A comparison will be required of the lessor's "active leasing expenses" for its pool of leased assets and its "adjusted leasing profit."

The legislative history goes to great length to explain that active leasing businesses that have benefitted from the exemption for Extraterritorial Taxable Income will be able to convert their operations to C.F.C.'s without a tax problem under Code §367(a) in order to take advantage of the repeal of the Subpart F Foreign Base Company Shipping Income rules.

II. U.S. Operations Abroad

A. Incentives to Reinvest Foreign Earnings in the U.S.

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules.

In general, the U.S. does not allow double tax to be relieved through a dividends received deduction of the type that is common in Europe and Canada. However, the Jobs Act modifies this for a short period of time, provided that certain stringent tests are met.

Under the Act, certain dividends received by a U.S. corporation from C.F.C.'s are eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction is available for dividends received either during the taxpayer's first taxable year beginning on or after the date of enactment of the bill, or during the taxpayer's last taxable year beginning before such date. Dividends received after the election period will be taxed in the normal manner under present law.

The deduction applies only to cash dividends and other cash amounts included in gross income as dividends, such as cash amounts treated as dividends under sections 302 or 304, but not to amounts treated as dividends under Code §§78, 367, or 1248. With one principal exception, the deduction does not apply to items that are not included in gross income as dividends, such as Subpart F inclusions or deemed repatriations under Code §956. Similarly, the deduction does not apply to distributions of earnings previously taxed under subpart F. However, the deduction will apply to a Subpart F inclusion that results from the payment of a dividend by one C.F.C. to another within a chain of ownership during the election period, with the result that cash travels through a chain of C.F.C.'s to the taxpayer within the election period.

The amount of dividends eligible for the deduction is reduced by any increase in related-party indebtedness on the part of a C.F.C. between October 3, 2004 and the close of the taxable year for which the deduction is being claimed, determined by treating all C.F.C.'s with respect to which the taxpayer is a U.S. shareholder as one C.F.C.This rule is intended to prevent a deduction from being claimed in cases in which the U.S. shareholder directly or indirectly (e.g., through a related party) finances the payment of a dividend from a C.F.C. In such a case, there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction.

The deduction is subject to a number of general limitations. First, it applies only to repatriations in excess of the taxpayer's average repatriation level over a base period consisting of three of the five most recent taxable years ending on or before June 30, 2003. The highest repatriation year and the lowest-repatriation year are not taken into account in determining the average. If there are fewer than five years, then all taxable years ending on or before June 30, 2003 are included in the base period.

Repatriation levels are determined by reference to base-period tax returns as filed, including any amended returns that were filed on or before June 30, 2003. U.S. shareholders that file a consolidated tax return are treated as one U.S. shareholder for all purposes of this dividends-received deduction provision. Thus, all such shareholders are aggregated in determining the base-period average, as are all C.F.C.'s. In addition to cash dividends, dividends of property, deemed repatriations under Code §956, and distributions of earnings previously taxed under Subpart F are included in the base-period average. Thus, these amounts can increase the average distribution during the base period, but do not qualify for the deduction if made during the specified period.

The second limitation is that the amount of dividends eligible for the deduction is limited to the greatest of several amounts. The first amount is $500 million. The second amount is the earnings shown as permanently invested outside the U.S. on the taxpayer's most recent audited financial statement which is certified on or before June 30, 2003. The third amount applies only in the case of an applicable financial statement that does not show a specific amount of permanently invested earnings. Here the amount is equal to the amount of earnings grossed up by a tax liability computed at a 35% rate. If the $500 million amount is used, it must be divided among corporations that are members of a 50% controlled group, using a 50-percent standard of common control. If either of the two financial statement ceilings is used, the ceiling must be divided among the U.S. shareholders that are included on those statements.

The third limitation is that the dividends must be part of a domestic reinvestment plan approved by the taxpayer's senior management and board of directors. This plan must provide for the reinvestment of the repatriated dividends in the United States. Among other things, reinvestment includes funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation. Other uses are permitted, except that the reinvestment plan cannot designate repatriated funds for use as payment for executive compensation.

No foreign tax credit or deduction is allowed for foreign taxes attributable to the deductible portion of any dividend. For this purpose, the taxpayer may specifically identify which dividends are treated as carrying the deduction and which dividends are not. In other words, the taxpayer is allowed to choose which of its dividends are treated as meeting the base period repatriation level, and thus carry foreign tax credits, to the extent otherwise allowable. The deduction itself will have the effect of appropriately reducing the taxpayer's foreign tax credit limitation.

No deduction will be allowed for expenses that are properly allocated and apportioned to the deductible portion of any dividend. The income attributable to the nondeductible portion of a

qualifying dividend may not be offset by expenses, losses, or deductions, and the tax attributable to such income generally may not be offset by credits other than foreign tax credits and AMT credits. The tax on this amount also cannot reduce the alternative minimum tax that otherwise would be owed by the taxpayer. However, the deduction available under this provision is not treated as a preference item for purposes of computing the AMT. Thus, the deduction is allowed in computing alternative minimum taxable income notwithstanding the fact that it may not be deductible in computing earnings and profits. No deduction under sections 243 or 245 is allowed for any dividend for which a deduction is allowed under the provision.

The provision is effective only for a taxpayer's first taxable year beginning on or after the date of enactment of the bill, or the taxpayer's last taxable year beginning before such date, at the taxpayer's election. The deduction available under the provision is not allowed for dividends received in any taxable year beginning one year or more after the date of enactment.

B. Repeal of Foreign Personal Holding Company & Foreign Investment Company Rules

U.S. law contains several sets of anti-deferral rules. These include (i) Subpart F for all U.S. taxpayers that are U.S. Shareholders of C.F.C.'s, (ii) P.F.I.C. rules for any U.S. person who owns shares in a foreign fund, as defined, (iii) Foreign Personal Holding Company rules for U.S. individuals and their closely-held U.S. companies that are shareholders in closely held Foreign Personal Holding Companies as defined, (iv) the Personal Holding Company rules for individuals that own closely-held companies, (v); the Accumulated Earnings Tax rules for companies that unreasonably accumulate earnings, thereby allowing shareholders to avoid tax on the personal level, and (vi) the Foreign Investment Company rules for offshore funds.

Although U.S. tax law contains rules intended to coordinate the application of the various anti-deferral provisions, unhappy surprises occur in unexpected circumstances, especially when companies are privately held. This has been changed by the Jobs Act. The Act eliminates the rules applicable to foreign personal holding companies. Instead, it treats as Foreign Personal Holding Company income personal services contract income that is subject to the present-law foreign personal holding company rules. As a result, the income from these service contracts can be taxed in the U.S. even when they do not represent more than 60% or 50% of the gross income of the foreign corporation. The Act also excludes foreign corporations from the application of the Personal Holding Company Rules.

C. Look-through Treatment for Sales of Partnership Interests

Subpart F generally provides that U.S. taxpayers who are U.S. Shareholders of C.F.C.'s cannot claim the benefit of deferral from tax for income of C.F.C.'s that is treated as Subpart F Income. Subpart F Income includes Foreign Personal Holding Company Income, which in turn includes gains from the sale of interests in partnerships and trusts. Thus, no deferral is permitted for gains derived by a C.F.C. from the sale of a partnership interest.

The Jobs Act revises this treatment. The sale of a partnership interest by a C.F.C. is treated as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule applies only to partners owning directly, indirectly, or constructively at least 25% of a capital or profits interest in the partnership. Thus, the sale of a partnership interest by a C.F.C. that meets the ownership threshold will generate Subpart F Income only to the extent that the gain is attributable to underlying partnership assets that, if owned directly by the C.F.C., would generate Subpart F Income.

D. Foreign Personal Holding Company Income Arising from Transactions in Commodities

Under Subpart F of current law, Foreign Personal Holding Company Income includes net gains from transactions in commodities. However, gains or losses that arise out of *bona fide* hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others are not considered to be items of Foreign Personal Holding Company Income. Also excluded are active business gains or losses from the sale of commodities, but only if substantially all of the C.F.C.'s business is as an active producer, processor, merchant, or handler of commodities. Current law also provides that the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the I.R.S. may by regulations prescribe). The term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the I.R.S. may prescribe in regulations.

The Jobs Act modifies existing rules. Under the Act, gains or losses derived by a C.F.C. from a transaction with respect to a commodity are not treated as items of Foreign Personal Holding Company Income if the transaction satisfies the general definition of a hedging transaction under the Code. For this purpose, the general definition of a hedging transaction under Code §1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a C.F.C. in the normal course of its trade or business primarily (i) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in Code §1231(b) which is held or to be held by the C.F.C. or (ii) to manage such other risks as the I.R.S. may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions.

The Act also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding

company income. Now, substantially all of the C.F.C.'s commodities must consist of (a) stock in trade or other property of a kind which would properly be included in the inventory or property held primarily for sale to customers in the ordinary course of business, (b) depreciable property is used in the business of the C.F.C., or (c) supplies of a type regularly used or consumed in the ordinary course of a trade or business.

E. Active Financing Business under Subpart F

Current law provides an exception to the Foreign Personal Holding Company Income rules, Foreign Base Company Services Income, and Subpart F Insurance Income for income derived by a C.F.C. in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business. To qualify for favorable tax treatment, the C.F.C. is required to be predominantly engaged in the business and to conduct the activities through its employees. These activities must be conducted through a qualified business unit in the C.F.C.'s country of incorporation.

The Jobs Act loosens some of the foregoing requirements. Under the Act, an activity is treated as conducted directly by the C.F.C. or QBU in its home country if the activity is performed by employees of a related person. For this rule to apply, the related person is itself an eligible C.F.C., its home country must be the same as that of the C.F.C., the activity must be performed in the home country of the related person, the related person must be compensated on an arm's length basis for the performance of the activity by its employees, and the compensation must be treated as earned by the related person in its home country for purposes of the tax laws of that country.

F. U.S. Property Excludes Certain Financial Assets of C.F.C.

In general, the subpart F rules require that a "U.S. Shareholder" of a C.F.C. must include in income on a current basis its pro rata share of the Subpart F income of the C.F.C. the earnings arising from that income are not distributed currently to shareholders. In addition, a U.S. Shareholder of a C.F.C. must include in income on a current basis its pro rata share of the C.F.C.'s earnings that are invested in "U.S. property" by the C.F.C. For this purpose, the U.S. property held by the C.F.C. is the property's adjusted basis, reduced by any liability to which the property is subject. The analysis is made four times during the year, on the last day of each quarter, and the amount of the investment is the average of the amounts on each of those days. An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the C.F.C.'s earnings that have been previously taxed as Subpart F Income.

The Jobs Act adds two new exceptions from the definition of U.S. property for determining current income inclusion by a U.S. 10-percent shareholder with respect to an investment in U.S. property by a C.F.C. The first exception is securities acquired and held by a C.F.C. in the ordinary course of its business as a dealer in securities. The C.F.C. must (i) account for the securities as securities held primarily for sale to customers in the ordinary course of business and (ii) disposes of the securities (or the securities mature) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

The second exception is for obligations issued by a U.S. person that is not a U.S. corporation. Thus, it could be a partnership or an L.L.C. To come within the exception, the issuer must not be a 10% shareholder of the C.F.C. or a partnership, estate or trust in which the C.F.C. or any related person is a partner, beneficiary or trustee immediately after the acquisition of the obligations.

The amendments apply to tax years of foreign corporations beginning after 2004 and to tax years of U.S. shareholders with or within which such tax years of foreign corporations end.

III. Foreign Tax Credit

A. 10-Year Foreign Tax Credit Carryover; 1-Year Carryback

U.S. law provides relief when the amount of creditable foreign income taxes exceeds the foreign tax credit limitation. The excess may be carried back to the two immediately preceding taxable years and carried forward five taxable years. If excess limitation exists in a year to which carried, the foreign tax is treated as if paid in that year. Excess credits are carried forward or carried back on a separate limitation basis.

The Jobs Act revises the number of years to which unused foreign taxes may be carried. The carryback period is reduced from two years to one year; the carryforward period is increased from five years to ten years. The new one-year carryback provision applies to excess foreign taxes arising in taxable years beginning after the date of enactment of the Act. The new ten-year carryforward provision applies to excess foreign taxes which could have been to any taxable year ending after October 22, 2004, the date of enactment under prior law.

B. Reduction to Two Foreign Tax Credit Baskets

Because foreign-source income earned by U.S. persons may be subject to double taxation, U.S. tax law allows taxpayers to claim a credit against their U.S. tax liability for foreign income taxes paid. The foreign tax credit is subject to a number of limitations. First, the foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S. source income. Second, in order to prevent taxpayers from averaging high tax operating income with low tax income, the foreign tax credit limitation is applied separately to several categories of income, including (a) passive income, (b) high withholding tax interest, (c) financial services income, (d) shipping income, (e) certain dividends received from 10/50 corporations, (f) dividends from a D.I.S.C., (g) taxable income attributable to foreign trade income, (h) distributions from a F.S.C., and (i) all other income. Foreign taxes are allocated and apportioned to the same limitation categories. If foreign law imposes tax on an item of income that does not constitute income under U.S. tax principles, the tax is treated as imposed on income in the general limitation category.

The Jobs Act reduces the number of foreign tax credit limitation categories to two – passive category income and general category income. Passive category income includes passive income and items categorized as specified passive category income. Specified passive category income includes distributions from a D.I.S.C. and a F.S.C. and foreign trade income. Income that is not passive category income qualifies as general category income. In the case of a member of a financial service group or any other person predominantly engaged in the financial services business, financial services income will be treated as general category income. This provision is effective for tax years beginning after 2006.

The Act also provides that foreign tax on amounts not treated as income for U.S. tax purposes will be assigned to the general category income basket. This provision is effective for tax years beginning after 2006. For taxes paid or accrued in tax years beginning after 2004 and before 2007, a taxpayer may elect to have such amounts assigned to either the general limitation income or the financial services income.

C. Interest Expense Allocation Rules

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, a taxpayer must allocate and apportion deductions between items of U.S. source gross income, on the one hand, and items of foreign-source gross income, on the other. In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. For interest allocation purposes, the Code provides that all members of an affiliated group of corporations generally are treated as a single corporation and that the allocation must be made on the basis of assets rather than gross income.

The existing rules are problematic for multinational groups that are heavily leveraged both in the U.S. and abroad. Even if a foreign subsidiary bears its own borrowing costs entirely, a portion of the U.S. parent company's interest expense must be allocated to the investment in the foreign subsidiary.

The Jobs Act revises the allocation rules. If a taxpayer elects, the interest expense of a domestic affiliated group is allocated to foreign source income only if the domestic group is more highly leveraged than its foreign affiliates. For this purpose, foreign corporations are included in the computation if they are at least 80% owned (by vote and value) by members of the U.S. affiliated group.

If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the U.S. is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in the following way. First, the worldwide affiliated group's worldwide third-party interest expense is multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group. Second, the third-party interest expense incurred by foreign members of the group

that would be allocated to foreign source incomes is determined as if the provision's principles were applied separately to the foreign members of the group. If the former amount exceeds the latter amount, the excess is determined. The domestic group's interest expense is allocated to foreign source income to the extent of that excess.

The Job Act also allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The provision also provides a one-time "financial institution group" election that expands the present-law bank group.

The provision is elective for the first tax year beginning after 2008.

D. Overall Foreign Loss Recapture

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The amount of foreign tax credits generally is limited to a portion of the taxpayer's U.S. tax which portion is calculated by multiplying the taxpayer's total U.S. tax by a fraction, the numerator of which is the taxpayer's foreign-source taxable income (i.e., foreign-source gross income less allocable expenses or deductions) and the denominator of which is the taxpayer's worldwide taxable income for the year.

Special recapture rules apply in the case of foreign losses for purposes of applying the foreign tax credit limitation. Under these rules, losses for any taxable year in a limitation category which exceed the aggregate amount of foreign income earned in other limitation categories (a so-called "overall foreign loss") are recaptured by re-sourcing foreign-source income earned in a subsequent year as U.S. source income. The amount re-sourced as U.S. source income generally is limited to the lesser of the amount of the overall foreign losses not previously recaptured, or 50% of the taxpayer's foreign-source income in a given year. Taxpayers may elect to recapture a larger percentage of such losses.

A special recapture rule applies to ensure the recapture of an overall foreign loss where property which was used in a trade or business predominantly outside the United States is disposed of prior to the time the loss has been recaptured. In this regard, dispositions of trade or business property used predominantly outside the United States are treated as resulting in the recognition of foreign-source income (regardless of whether gain would otherwise be recognized upon disposition of the assets), in an amount equal to the lesser of the excess of the fair market value of such property over its adjusted basis, or the amount of unrecaptured overall foreign losses. Such foreign-source income is re-sourced as U.S. source income without regard to the 50% limit.

The Jobs Act extends the scope of the special recapture rule for overall foreign losses to the disposition of stock in a C.F.C. controlled by a U.S. taxpayer. The disposition of the shares results in the recognition of foreign-source income in an amount equal to the lesser of the fair market value of the stock over its adjusted basis, or the amount of prior unrecaptured overall foreign losses. That

income is re-sourced as U.S. source income for foreign tax credit limitation purposes without regard to the 50% limit. Although the provision generally extends to all dispositions of stock in a controlled C.F.C. regardless of whether gain or loss is recognized on the transfer, exceptions are made for transfers that are part of an internal restructuring. Contributions to corporations or partnerships that are tax-free under Code §§351 and 721and certain stock and asset reorganizations do not trigger recapture of overall foreign losses, provided that the transferor's underlying indirect interest in the disposed C.F.C. does not change. However, any gain recognized in connection with a transaction meeting any of these exceptions, such as boot, triggers recapture of overall foreign losses to the extent of such gain. In addition, a disposition of stock in controlled C.F.C. in a transaction in which the taxpayer or a member of its consolidated group acquires the assets of the C.F.C. in a liquidation that is tax-free under Code §332 or a reorganization does not trigger the recapture of overall foreign losses. Any gain recognized in connection with a transaction meeting this exception triggers recapture of overall foreign losses to the extent of such gain.

E. Recharacterization of Overall Domestic Loss

Under Code §904(f), a portion of foreign-source taxable income earned after an overall-foreign loss is recognized in an earlier year is recaptured and recharacterized as U.S. source taxable income for foreign tax credit purposes. This was initially intended to prevent taxpayers from having a double tax benefit from foreign operations. The first would be attributable to a reduction in income by reason of foreign losses and the second would be a reduction of tax by reason of the foreign tax credit. However, many taxpayers find that U.S. losses can prevent the foreign tax credit from being fully utilized because the losses reduce taxable income.

The Jobs Act addresses this issue by providing a provision for the recapture of U.S. source losses. Under the provision, a portion of the taxpayer's U.S. source income for each tax year after an overall-domestic-loss year is recharacterized as foreign-source income in an amount equal to the lesser of: (1) the amount of the unrecharacterized overall domestic losses for prior years and (2) 50% of the taxpayer's U.S. source income for a succeeding taxable year. Any U.S. source income recharacterized under the provision is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic losses, in a manner similar to the recharacterization rules for separate limitation losses.

This provision applies to losses incurred in tax years beginning after 2006.

F. Indirect Foreign Tax Credits – Attribution of Stock Ownership Through Partnerships

A domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of the dividend to the foreign corporation's post-1986 undistributed earnings and profits.

In Rev. Rul. 71-141, the I.R.S. held that a foreign corporation's stock held indirectly by two domestic corporations through their interests in a domestic general partnership is attributed to such domestic corporations for purposes of determining the domestic corporations' eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation. However, in 1997, the Treasury Department issued final regulations under the foreign tax credit. The preamble to the regulations stated that the final regulations do not resolve the extent to which Rev. Rul 71-141 is applicable to dividends received through partnerships or other passthrough entities.

The Jobs Act resolves the issue identified by the I.R.S. A domestic corporation is entitled to claim deem-paid foreign tax credits with respect a foreign corporation held indirectly through either a foreign or a U.S. partnership if the domestic corporation owns (indirectly through the partnership) 10 percent or more of the foreign corporation's voting stock.

G. Look-Through Rules to Apply to Dividends from 10/50 Corporations

In order to provide relief against double taxation, U.S. law contains a foreign tax credit provision Under the credit, U.S. taxpayers may credit foreign income taxes against U.S. tax on foreign-source income. In general, the amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are also applied to specific categories of income.

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10% of the stock by vote and which is not a C.F.C. That type of company is frequently referred to as a "10/50 company." Dividends paid by a 10/50 company that is not a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 are subject to a single foreign tax credit limitation for all 10/50 company (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the 10/50 company's earnings and profits attributable to income in such foreign tax credit limitation categories to its total earnings and profits.

The Jobs Act revises the separate limitation rule by providing look-through treatment for dividends received from 10/50 regardless of the year in which the earnings and profits out of which the dividend is paid are accumulated. However, the dividend will be assigned to the passive category income if the taxpayer cannot adequately substantiate the proper foreign tax credit basket to which the dividend should be assigned.

This provision is effective for tax years beginning after 2002.

H. Translation of Foreign Taxes

Code §986 provides a special translation rule for computing the U.S. dollar value of foreign taxes available for credit. The rule applies to taxpayers who account for foreign taxes under the accrual method. Under the rule, the amount of the foreign income tax (and any adjustment thereto) is translated into dollars by using the average exchange rate for the tax year to which the tax relates.

The Jobs Act modifies current law by providing an election for taxpayers currently required to use the average exchange rate. These taxpayers may elect to translate certain foreign taxes using the exchange rates as of the date the taxes are paid. Only foreign income taxes that are not paid in the taxpayer's functional currency are affected. In addition, this election is not available to accrual-basis R.I.C.'s, which must use the applicable exchange rates as the income accrues.

Once made, the election is binding on subsequent tax years and may be revoked only with the consent of the I.R.S.

I. Code §367(d) – Transfers of Intangible Property

U.S. tax law treats the transfer of intangible property to foreign corporations by means of contributions and other nonrecognition transactions as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign corporation to which the intangible was transferred are reduced by such amounts. The source of the deemed payments received is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income. However, existing law is unclear with regard to the proper foreign tax credit basket for the deemed payments. If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category under the look-through rules applicable to payments of dividends, interest, rents, and royalties from C.F.C.'s.

The Jobs Act eliminates the uncertainty by providing that deemed payments under Code §367(d) are treated as royalties for purposes of applying the separate limitation categories of the foreign tax credit. The provision is effective for amounts treated as received on or after August 7, 1997.

J. AMT – Repeal of 90% Limitation on Foreign Tax Credit

Taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20%, in the case of corporate taxpayers. The base is alternative minimum taxable income in excess of an exemption amount that phases out. Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. However, the AMT foreign tax credit may not

offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90% of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit.

The Jobs Act repeals the 90% limitation on the utilization of the AMT foreign tax credit.

IV. Investments into the U.S.

A. Study of Earnings Stripping Provisions

Code §163(j) limits the ability of U.S. corporations to reduce taxable income by claiming deductions for interest expense on loans from related foreign parties when interest paid to the related party is not subject to full 30% withholding tax. A similar rule applies to loans of U.S. corporations that are guaranteed by related foreign persons. These rules limit the deductibility of interest paid to certain related parties ("disqualified interest"), if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion).

At various times in recent years, Congress and the Administration have put forward legislative proposals to tighten the limitation in order to further reduce the amount of taxable income that can be reduced by related party interest expense. While no provisions were enacted as part of the Jobs Act to further limit deductions that can be claimed by corporations, the Act requires the Treasury Department to conduct a study of the earnings. The study is to address the following issues: (i) their effectiveness in preventing the shifting of income away from the U.S., (ii) whether they place U.S.-based businesses at a competitive disadvantage relative to foreign-based businesses, (iii) their impact on the U.S. tax base, (iv) whether laws of foreign countries facilitate the stripping of earnings away from the U.S., and (v) whether changes would affect jobs in the U.S. The study is to include specific recommendations for improving these rules and is to be submitted to the Congress not later than June 30, 2005.

B. Modification of F.I.R.P.T.A. Rules for Foreign Investors in a R.E.I.T.

A real estate investment trust ("R.E.I.T.") is a U.S. entity that derives most of its income from passive real estate-related investments. A R.E.I.T. must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for R.E.I.T. status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the R.E.I.T., and includible in income by its investors. In this manner, the distributed income of the R.E.I.T. is not taxed at the entity level. The distributed income is taxed only at the investor level.

Where a R.E.I.T. has foreign investors, the treatment of the R.E.I.T. and its distributions are subject to special rules under F.I.R.P.T.A. The receipt by a foreign investor of a distribution from a R.E.I.T. is treated as a disposition of a U.S. real property interest to the extent attributable to a sale or

exchange of a U.S. real property interest by the R.E.I.T. These capital gains distributions from R.E.I.T.'s generally are subject to withholding tax at a rate of 35% or a lower rate under an applicable income tax treaty. The foreign investor in the R.E.I.T. is required to file Federal income tax returns on which the effectively connected income is reported. Foreign corporations that invest in R.E.I.T's are also subject to the branch profits tax of 30% or the lower treaty rate.

The Jobs Act makes several changes to the foregoing tax treatment. First, a capital gain distribution by a R.E.I.T. is no longer treated as effectively connected income if certain conditions are met. The distribution must be made with respect to a class of stock that is regularly traded on an established securities market located in the United States and the foreign investor must not own more than 5% of the class of stock at any time during the taxable year in which the distribution is received. Second, because the distribution is no longer treated as effectively connected income, a foreign investor is not required to file a U.S. Federal income tax return by reason of having received the R.E.I.T. distribution. Finally, the branch profits tax no longer applies to a capital gains distribution.

C. R.I.C. Dividends

A regulated investment company ("R.I.C.") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). To qualify as a R.I.C., a corporation must elect such status and must satisfy certain tests. Among other things, the corporation must derive at least 90% of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a R.I.C. pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class. A limited exception to this rule applies for persons who invest more than $10 million.

A R.I.C. generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the R.I.C. has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A R.I.C. generally also can pass through to its shareholders the character of tax-exempt interest from State and local bonds if certain conditions are met. In this case, the R.I.C. generally may designate a dividend it pays as an exempt-interest dividend to the extent that the R.I.C. has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

The U.S. generally imposes a flat 30% tax on the gross amount of U.S. source investment income payments, such as interest. However, not all interest income derived by foreign investors is subject

to this tax. Bank deposit interest, short-term O.I.D., and interest on portfolio debt as defined are exempt from the 30% tax. In general, the estate tax treatment regarding the estates of foreign individuals follows the income tax treatment. The Jobs Act allows the income and estate tax treatment of these investments to flow through to foreign investors in a R.I.C. for a limited period of time.

Under the Act, a R.I.C. that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the R.I.C. generally would treat the dividend as exempt from gross-basis U.S. tax, as if the foreign person had earned the interest directly. To be entitled to this treatment, the withholding agent must receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption does not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the I.R.S. has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons. In addition, the exemption generally does not apply to dividends paid to a C.F.C. to the extent such dividends are attributable to income received by the R.I.C. on a debt obligation of a person with respect to which the recipient of the dividend (i.e., the C.F.C.) is a related person. Nor does the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term O.I.D. or bank deposit interest) received by the R.I.C. on indebtedness issued by the R.I.C. dividend recipient or by any corporation or partnership with respect to which the recipient of the R.I.C. dividend is a 10% shareholder.

Similarly, a R.I.C. that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, generally may, to the extent of such excess, designate a dividend it pays as derived from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had realized the excess directly. In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. Rules are adopted to coordinate with F.I.R.P.T.A. Thus, any distribution by a R.I.C. to a foreign person will, to the extent attributable to gains from sales or exchanges by the R.I..C. of an asset that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. In addition, the special rules for domestically-controlled R.E.I.T.'s are extended to domestically controlled R.I.C.'s.

Finally, the estate of a foreign decedent is exempt from U.S. estate tax on a transfer at death of stock in the R.I.C. in the proportion that the assets held by the R.I.C. is debt obligations, deposits, or other property that would generally be treated as situated outside the U.S. if held directly by the estate.

The new rules generally apply dividends paid with respect to taxable years of R.I.C.'s beginning after December 31, 2004, and before January 1, 2008. The new rules apply for estate tax purposes, to estates of decedents dying after December 31, 2004 and before January 1, 2008.

D. Interest Income Paid by Foreign Partnerships and Corporations

In general, interest income from interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S. source income. Other interest, such as interest on obligations of foreign corporations and foreign partnerships, generally is treated as foreign-source income. However, income tax regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the U.S. Consequently, that interest generates U.S. source interest, potentially subject to U.S. withholding tax when paid to a foreign recipient. In addition, if a foreign corporation derives income that is treated as effectively connected with the conduct of a U.S. trade or business, interest paid by that U.S. trade or business is treated as if it were paid by a domestic corporation and is also treated as U.S. source income that is potentially subject to U.S. withholding tax.

The Jobs Act modifies that treatment. Interest paid by a foreign partnership will be treated in a manner similar to the treatment of interest paid by a foreign corporation. Consequently, the interest will be treated as U.S. source income only if paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. This rule applies only to foreign partnerships that are predominantly engaged in the active conduct of a trade or business outside the United States.

E. Dividends From Foreign Corporations – Repeal of Withholding Tax

Under current Code §861(a)(2)(B), if a foreign corporation derives 25% or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, a proportionate amount of the dividends paid by the corporation is treated as U.S. source income. That dividend is subject to U.S. dividend withholding tax if paid to a foreign person. This rule does not apply if the foreign corporation is subject to branch profits tax.

The Jobs Act eliminates the withholding tax by adding Code § 871(i)(2)(D). It provides that dividends paid by a foreign corporation with U.S. operations will not be subject to withholding tax. It should be noted that the Act does not change the source of the dividend income. The dividend remains U.S. source income.

This provision is effective for payments made after December 31, 2004.

F. Withholding Tax Rate for Dividends to Puerto Rico Corporations

Corporations organized in the U.S. possessions of the Virgin Islands, Guam, American Samoa or the Northern Mariana Islands are not subject to withholding tax on dividends paid by U.S. corporations. While these possessions corporations are considered to be foreign corporations, the 30% withholding tax is not applicable. To be entitled to this benefit, certain local ownership and activity requirements must be met. In comparison to that treatment, dividends paid by a U.S. corporation to a corporation organized in Puerto Rico are subject to the ordinary 30% withholding tax.

The Jobs Act reduces the withholding tax rate on dividends paid to Puerto Rico corporations. Provided that the ownership test applicable to the other possessions corporations are met, the withholding tax rate is reduced to 10%.

G. Exclusion of Horse Racing and Dog Racing Gambling Winnings

Gambling winnings received by a nonresident alien from wagers placed in the United States are considered to be U.S. source income are subject to this withholding tax, unless exempted by treaty. Currently, several U.S. income tax treaties exempt U.S. source gambling winnings of residents of the other treaty country from U.S. withholding tax. With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the U.S. on a pari-mutuel event taking place within the U.S., the source of the winnings depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (e.g., a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the United States), the winnings would be deemed to arise from sources outside the U.S. and would not be taxed. However, if the payout is made from a "merged" or "commingled" pool, in which betting pools in the U.S. and the foreign country are combined, the portion of the payout attributable to wagers placed in the U.S. could be subject to withholding tax. The party making the payment, in this case a racetrack or off-track betting parlor in a foreign country, would be responsible for withholding the tax.

The Jobs Act modifies this treatment. Under the Act, an exclusion from gross income is provided for winnings paid to a nonresident alien resulting from a legal wager initiated outside the U.S. in a pari-mutuel pool on a live horse or dog race in the U.S., even if the pool is a merged U.S.-foreign pool.

V. Attack on Certain Cross-Border Financial Products

A. Investment in U.S. Property – Bank Deposit Exception

As previously mentioned, the subpart F rules require that a "U.S. Shareholder" of a C.F.C. must include in income on a current basis its pro rata share of the C.F.C.'s earnings that are invested in U.S. property. In determining whether a C.F.C. holds an item of U.S. property, an exception is

provided for deposits with persons carrying on the banking business. In The Limited, Inc. v. Commr., 286 F.3d 324 (6th Cir. 2002), revg. 113 T.C. 169 (1999), a U.S. Shareholder of a C.F.C. formed a subsidiary to carry on the private label credit card program of the U.S. shareholder. The U.S. shareholder was actively engaged in the retail business in the U.S. The Appellate Court concluded that the U.S. subsidiary was carrying on the banking business by reason of its credit card operation. Consequently, the C.F.C. could purchase certificates of deposit issued by the subsidiary without being viewed to have made an investment in U.S. property.

The Act reverses the holding in The Limited. As of the date of enactment, Code §956 provides that the exception from the definition of U.S. property for deposits with persons carrying on the banking business is limited to deposits with a qualified bank. For this purpose a qualified bank is (i) any bank as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c), without regard to paragraphs (C) and (G) thereof or (ii) any other corporation with respect to which a bank holding company or a financial holding company owns directly or indirectly more than 80% of the stock, determined by reference to voting power or value.

B. Importation of Losses

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation. The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor. The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor. At times, these rules have formed the basis of certain corporate tax shelters involving high basis/low value assets. Where that type of assets has been acquired in a tax-free reorganization or a tax-free organization of a U.S. corporation, the existing losses could be imported into the U.S. and ultimately used to offset capital gains arising from other assets.

To prevent the use of this type of planning device, Code §362(e) is enacted. It provides that, if a net built-in loss is imported into the U.S. in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property transferred will be limited to fair market value. A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary. A net built-in loss is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceed the fair market value of the properties transferred. If some properties are received by a corporation from U.S. persons subject to tax and other properties are received from foreign persons not subject to U.S. tax, this provision applies only to property received from the foreign persons. In the case of a transfer by a partnership (either domestic or foreign), this provision applies as if the properties had been transferred by each of the partners in proportion to their interests in the partnership.

If the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceed the aggregate fair market value of the property transferred in a tax-free incorporation, the transferee's aggregate basis of the properties is limited to the aggregate fair market value of the transferred property. Any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. The transferor and transferee may elect to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred. The election is included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs and, once made, is irrevocable.

C. Mismatching of Interest/O.I.D. Expense and Income Inclusion

As a general rule, deductions are allowed for interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount ("O.I.D.") of the issuer for the days during the taxable year. However, if a debt instrument is held by a related foreign person, the deduction for O.I.D. is deferred until paid. This rule does not apply, *inter alia*, to the extent that the O.I.D. arises from a debt owed to a foreign personal holding company (an "F.P.H.C."), a C.F.C., or a passive foreign investment company ("P.F.I.C."). For O.I.D. accruing to those entities, a deduction is allowed for O.I.D. as of the day on which the amount is includible in the income of the F.P.H.C., C.F.C., or P.F.I.C.

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee. With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation). As in the case of O.I.D., the Treasury regulations additionally provide that in the case of stated interest owed to an F.P.H.C., C.F.C., or P.F.I.C., a deduction is allowed as of the day on which the amount is includible in the income of the F.P.H.C., C.F.C., or P.F.I.C.

The Jobs Act further limits the amount deductible for accrued but unpaid amounts when the F.P.H.C., C.F.C., or P.F.I.C. is not wholly owned by the payor of the expense. Under the Act, deductions for amounts accrued but unpaid to a related F.P.H.C., C.F.C., or P.F.I.C. are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation. Deductions that have accrued but are not allowable under this provision are allowed when the amounts are paid. For purposes of determining the amount of the deduction allowable, the extent that an amount attributable to O.I.D. or an item is includible in the income of a U.S. person is determined without regard to (1) properly allocable deductions of the related foreign corporation, and (2) qualified deficits of the related foreign corporation under Code §952(c)(1)(B). Properly allocable

deductions of the related foreign corporation are those expenses, losses, and other deductible amounts of the related foreign corporation that are properly allocated or apportioned, under the principles of Code §954(b)(5), to the relevant income item of the related foreign corporation. Thus for example if a U.S. Shareholder owns 60% of a C.F.C. and accrues $100 of unpaid O.I.D. to the C.F.C., a deduction is allowed for $60 at the time of the accrual. It does not matter that the C.F.C. has deductions that are properly allocable to the income, and as a result, reports less than $100 of net Subpart F income. The balance is deductible upon payment.

The legislative history makes clear that other reductions in the amount included in income by the U.S. owners could further limit the amount that is currently deductible for the accrued but unpaid item. For example, if a C.F.C. reports a positive amount of net foreign base company income but the earnings and profits limitation of Code §952(c)(1)(A) reduces what would otherwise be a U.S. Shareholder's pro rata share of the C.F.C.'s Subpart F income, the deduction will be reduced further. In the above example, if losses derived from other operations of the C.F.C. limit the earnings of the C.F.C. to $10, the amount included in the income of a U.S. Shareholder is limited to 60% of $10. Where that occurs, an arcane formula is applied and the deduction for the accrued but unpaid O.I.D. is limited to $42, under a formula that takes into account the amount that would be deductible in general ($60) plus the amount of the earnings of the C.F.C. ($10) and multiplies the sum by 60%.

The I.R.S. is granted regulatory authority to exempt transactions from these rules, including any transactions entered into by the payor in the ordinary course of a trade or business in which the payor is predominantly engaged, and (in the case of items other than O.I.D.) in which the payment of the accrued amounts occurs shortly after its accrual.

RLF/aw