

Client Alert

Latham & Watkins
Tax Department

New Limits on Foreign Tax Credits

On August 10, 2010, President Obama signed into law H.R. 1586, which among other things imposes limitations on the ability of US taxpayers to use foreign tax credits (FTCs) to reduce their US income tax liability. The Joint Committee on Taxation estimated the new tax provisions would raise approximately US \$10.8 billion.

Prevention of Foreign Tax Credit Splitting

In general, US individuals and corporations are taxed on their worldwide income. The US has a complex FTC system designed to prevent US taxpayers from incurring double taxation on foreign earnings that, subject to limitations, allows a US taxpayer to claim a FTC against its US tax liability for foreign income taxes paid or accrued. Prior to the new legislation, if a foreign tax is paid or accrued earlier than the underlying income is taken into account for US tax purposes (or if there is a permanent deferral of such income for US tax purposes), a US taxpayer could take a FTC with respect to such tax even though the related income is not currently subject to US taxation.

The new legislation imposes a broad matching rule to prevent this. Specifically, if there is a "foreign tax

credit splitting event," a US taxpayer cannot claim a FTC for the payment of foreign taxes before the taxable year in which the related income is taken into account by the US taxpayer. A foreign tax credit splitting event occurs with respect to a foreign income tax if the related income is or will be taken into account by a "covered person." A covered person includes (i) any entity in which the foreign taxpayer holds at least a 10 percent direct or indirect ownership interest (by vote or value), (ii) any person that holds at least a 10 percent direct or indirect ownership interest (by vote or value) in the foreign taxpayer and (iii) certain other persons related to the foreign taxpayer. Generally this provision applies to foreign income taxes paid or accrued (or deemed paid) in taxable years beginning after December 31, 2010.

Covered Asset Acquisitions

The legislation also denies FTCs for a portion of foreign income taxes paid or accrued with respect to foreign entities acquired in "covered asset acquisitions." In a covered asset acquisition, an asset basis step-up is obtained for US tax purposes but not for foreign tax purposes. A covered asset acquisition includes a stock purchase for which a Section 338(g) election is made, an acquisition of partnership interests

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where Section 754 is in effect and a transaction treated for US tax purposes as an asset acquisition and for foreign tax purposes as either a stock acquisition or a disregarded transaction.¹ This last category could include acquisitions of hybrid entities (flow-through entities for US tax purposes but regarded taxpayers for foreign tax purposes). The step-up in basis could result in a higher amount of net income subject to tax for foreign tax purposes than for US tax purposes.

The provision is intended to prevent the use of the "excess" foreign tax on such higher amount of foreign income as a credit against other income. To the extent a FTC is disallowed, the disqualified foreign income taxes are allowed as a deduction to the extent otherwise deductible under general US tax rules. This provision applies to covered asset acquisitions occurring after December 31, 2010, subject to certain grandfather provisions.

Investments in US Property

The legislation also limits FTCs with respect to certain deemed dividends from controlled foreign corporations (CFCs).² Generally, active earnings of a CFC are not subject to current US taxation until such earnings are distributed to its US shareholders. However, under Section 956, investments by a CFC in US property will in some cases be taxable as if the CFC had made a distribution to its US shareholders. Under the so-called "hopscotch" rule, the CFC is deemed to make the distribution directly to the US shareholder, even if the US shareholder owns the CFC indirectly through a chain of other CFCs. For FTC purposes, corporate US shareholders deemed to receive such distributions generally will be treated as having paid a share of the foreign income taxes paid by the lower-tier CFC. Prior to the legislation, this could result in a benefit to a US shareholder that would not exist if the cash was actually distributed up the chain.

The legislation limits the amount of foreign taxes that a US shareholder is deemed to pay with respect to such deemed distributions. The allowed FTC is the lesser of (i) the FTC computed without regard to this provision (*i.e.*, computed under the hopscotch rule) and (ii) the FTC computed using the amount of the foreign income taxes that would have been deemed to have been paid during the taxable year by the US shareholder if cash (in an amount equal to the amount of the deemed distribution and assuming there are no withholding taxes) were distributed in a series of distributions up the chain of ownership from the CFC to the US shareholder. This provision applies to investments in US property occurring after December 31, 2010.

Other Provisions

In general, because US tax law limits the use of FTCs to offset only that portion of US tax that is attributable to foreign source income, it is generally advantageous for taxpayers to have income treated as foreign source income and deductions allocated against US source income. The legislation modifies the existing rules for the allocation of interest deductions between US and foreign members of an affiliated group, further limiting the ability of taxpayers to allocate interest deductions against US-source income. This provision applies to taxable years beginning August 10, 2010.

The amount of FTCs a taxpayer may utilize is limited by a complex set of rules. This FTC limitation is applied separately to different baskets of income, generally passive income and other income. Some income tax treaties provide that a taxpayer may elect to designate as foreign-source income certain income that would otherwise be sourced to the US, which election generally provides a favorable result to the taxpayer. For taxable years beginning after August 10, 2010, the

legislation provides that if such an election is made, the FTC limitation will apply separately to such income, *i.e.*, such income will comprise its own separate basket, generally an unfavorable result for the taxpayer.

Endnotes

- ¹ All references herein to "Section" are to the Internal Revenue Code of 1986, as amended.
- ² In general, a CFC is a foreign corporation that is more than 50 percent owned (by vote or value) by one or more US shareholders that each own (directly, indirectly or constructively) at least 10 percent of the foreign corporation's voting power.

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