CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

The Education Jobs and Medicaid Assistance Act of 2010

August 11, 2010

I. Introduction

Yesterday, President Obama signed into law the Education Jobs and Medicaid Assistance Act of 2010 (H.R. 1586) (the "**Act**"). The Act allocates approximately $10 billion to local school districts to prevent teacher layoffs due to state revenue shortfalls, and approximately $16 billion to help states pay rising Medicaid costs without having to lay off public and private sector employees.

The Act funds approximately $1.1 billion of the allocations by eliminating the advance payment option for the earned income credit,[1] and approximately $9 billion of the allocations through several changes to the international provisions of the Internal Revenue Code. Part II of this memorandum lists these international tax law changes, and Part III explains them in greater detail.

II. Summary of the Tax Provisions of the Act

- **U.S. Foreign Tax Credit Changes.**
  - **Prevent splitting of foreign tax credits from income.** The Act denies foreign tax credits to taxpayers until the taxpayer reports the foreign income associated with the credit.
  - **Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of a "covered asset acquisition."** The Act denies U.S. taxpayers foreign tax credits with respect to income derived from the assets of an acquired "hybrid" entity that is treated as a

[1] Low-income individuals may be eligible for an "earned income tax credit", which first reduces the taxpayer's federal tax liability and, to the extent the credit exceeds the taxpayer's federal tax liability, is refundable. Under pre-Act law, eligible taxpayers may elect to receive an advance payment of a portion of the excess credit in their paycheck, rather than having to claim a refund on their tax return. The Act repeals the advance payment option for the earned income tax credit beginning after December 31, 2010.

corporation for foreign tax purposes, but as a partnership or disregarded entity for U.S. tax purposes to the extent that the hybrid entity permits the taxpayer to acquire a stepped-up basis in the hybrid entities' assets for U.S. tax purposes but not foreign tax purposes.

- **Separate application of foreign tax credit limitation to items under tax treaties.** The Act imposes a separate foreign tax credit limitation for income that is treated as foreign-source income under a treaty, but would otherwise have been U.S.-source income.
- **Limitation on tax credits resulting from the use of section 956.** The Act limits the amount of deemed-paid foreign tax credit that may be claimed through the affirmative use of section 956 to cause a deemed dividend from a lower-tier controlled foreign corporation (a "CFC") directly to the United States shareholders by providing that the section 956 deemed dividend is treated as if it was distributed by the lower-tier CFC up through each CFC in the chain of ownership.[2]

- **Other International Provisions.**
  - **Repeal of 80/20 company rules; interest paid by resident alien individuals.** The Act repeals the "80/20 company" rule, which provides that U.S. withholding tax does not apply to the interest or dividends paid by a U.S. corporation that derives at least 80% of its gross income from the active conduct of a foreign trade or business during a three-year testing period. Accordingly, under the Act, all dividends and interest paid by U.S. corporations to their foreign shareholders and creditors will be subject to a 30% U.S. withholding tax unless a tax treaty (or the portfolio interest exemption from withholding) applies.
  - **Modification of affiliation rules for interest allocation purposes.** The Act provides that a foreign subsidiary is treated as a member of a U.S. affiliated group for purposes of determining and apportioning the affiliated group's interest expense if at least 80% of its outstanding stock, by vote or value, is owned by members of the affiliated group and more than 50% of its gross income for the taxable year is effectively connected with the conduct of a U.S. trade or business. Moreover, under the Act, if a foreign corporation is a member of an affiliated group under this test, all of the

[2] All references to section numbers are to the Internal Revenue Code of 1986 as amended (the "**Code**"), or the Treasury regulations issued thereunder.

foreign corporation's assets and interest expense are taken into account for purposes of allocating and apportioning the interest expense of the affiliated group.

- **Prevent the avoidance of withholding tax on repatriations of earnings of a foreign subsidiary corporation to a foreign parent corporation where a U.S. corporation is the direct parent of the foreign subsidiary.** Under the Act, if more than 50% of a target corporation is acquired from a foreign person that is not a CFC, none of the foreign acquirer's earnings and profits will be taken into account in calculating the amount of any deemed dividend under section 304. This change will generally result in the imposition of a U.S. withholding tax on a foreign corporation that sells stock in a U.S. subsidiary to the U.S. subsidiary's foreign subsidiary to the extent that the U.S. subsidiary has earnings and profits.

The balance of this memorandum discusses these provisions in more detail.

III. International Tax Provisions

A. **Prevent splitting of foreign tax credits from income.** U.S. taxpayers may claim foreign tax credits with respect to foreign taxes paid. Under pre-Act law, a taxpayer may claim foreign tax credits if foreign law imposes a legal liability for the tax on the taxpayer, regardless of whether the taxpayer is required to include the associated earnings in income for U.S. federal income tax purposes.[3] Thus, it is possible under existing law for a U.S. taxpayer to earn foreign tax credits even though they are not required to report the underlying income for tax purposes. For example, in *Guardian Industries Corp v. United States*,[4] the taxpayer organized a domestic corporate subsidiary holding company which, in turn, organized a Luxembourg subsidiary that was disregarded for U.S. tax purposes but treated as a corporation for Luxembourg purposes (*i.e.*, a hybrid entity). The hybrid entity, in turn, organized a number of operating subsidiaries that were respected as corporations for both Luxembourg and U.S. tax purposes. Under Luxembourg law, the tax liability was imposed on the hybrid entity. The Guardian court held that, because the hybrid entity was disregarded for U.S. tax purposes, the domestic holding company was liable for the Luxembourg tax for purposes of the foreign income tax credit. Consequently, because the foreign tax credit was deemed to

[3] Treasury regulations section 1.901-2(f)(1) (the taxpayer on whom foreign law imposes "legal liability" for the tax is the person by whom tax is considered paid).

[4] 477 F.2d 1368 (Fed. Cir. 2007).

be imposed (through the hybrid entity) on the U.S. parent, the U.S. taxpayer was entitled to a foreign tax credit even though, because the income was deemed to be earned by the foreign operating companies and was not Subpart F income, the U.S. taxpayer could continue to defer tax on the income earned by the foreign operating subsidiaries.

The Act denies foreign tax credits to U.S. taxpayers (such as Guardian) until the taxpayers report the associated foreign income (and permits foreign tax credits only to the extent that the taxpayer reports the associated foreign income). The provision applies to all "split" foreign taxes claimed by taxpayers after December 31, 2010.

B. **Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions.** If a taxpayer acquires an interest in a "hybrid" entity that is treated as a corporation for foreign tax purposes and as a partnership or disregarded entity for U.S. tax purposes, (referred to as a "covered asset" acquisition) the taxpayer may receive an "inside" tax basis for U.S. federal tax purposes equal to the purchase price, which may exceed the entity's basis in its assets for foreign tax purposes. In this case, the amount of depreciation allowed for U.S. tax purposes with respect to the acquired assets may exceed the amount of depreciation allowed for foreign tax purposes, resulting in lower U.S. taxable income than taxable income for purposes of the foreign jurisdiction. In this case, under pre-Act law, the taxpayer would receive foreign tax credits based on an amount of foreign income that exceeds the taxpayer's U.S. taxable income with respect to the entity, and therefore the taxpayer's foreign tax credits may be greater than necessary to avoid double tax on the U.S. taxable income. The Act creates new section 901(m), which disallows foreign tax credits with respect to the amount of foreign taxable income that exceeds U.S. taxable income resulting from a covered asset acquisition. This provision applies to acquisitions occurring after December 31, 2010. However, this provision will not apply to any covered asset acquisition that was (i) made pursuant to a written agreement that was binding on January 1, 2011, and at all times thereafter, (ii) described in a ruling request submitted to the IRS on or before July 29, 2010, or (iii) described in a public announcement or in a filing with the SEC on or before January 1, 2011.

C. **Separate application of foreign tax credit limitation to items under tax treaties.** Foreign tax credits are limited to the maximum amount of U.S. tax that could be imposed on the taxpayer's foreign-source income (*i.e.*, 35% of the foreign-source

income).[5] Certain U.S. tax treaties provide that income received on U.S. assets owned through a foreign branch is treated as foreign-source income for U.S federal tax purposes. This treatment increases the taxpayer's foreign-source income and therefore increases its foreign tax credits limitation. Without the benefit of a treaty, the income would be U.S.-source income, and would not increase the taxpayer's foreign tax credit limitation. The Act provides that foreign tax credits with respect to foreign-source income that in the absence of a tax treaty would have been U.S.-source income are allowed only with respect to that foreign-source income, and cannot be used to offset U.S. taxes with respect to other foreign-source income. This provision applies for taxable years beginning after the date of enactment.

D. **Limitation on tax credits resulting from the use of section 956.** U.S. corporations that own an interest in a CFC are generally entitled to a "deemed-paid foreign tax credit" equal to their proportionate share of the foreign taxes paid by the CFC. A taxpayer's proportionate share of CFC foreign taxes paid is calculated by dividing the taxpayer's Subpart F income inclusions by the CFC's earnings and profits. Under pre-Act section 956, United States shareholders of a CFC must generally include in income their share of United States property acquired by the CFC.[6] Additionally, under section 956, if a CFC owns an upper-tier subsidiary CFC and the lower-tier CFC invests in United States property, the United States shareholder is treated as receiving a direct distribution from the lower-tier subsidiary (and not as if the lower-tier subsidiary made a distribution through the upper-tier subsidiary of CFCs to the United States shareholder).[7] Therefore, the United States shareholder's deemed-paid foreign tax credits with respect to a lower-tier CFC is determined solely by reference to the lower-tier CFC's foreign taxes paid and earnings and profits (and not at all by upper-tier subsidiary's). This rule may have the effect of generating more foreign tax credits for each dollar of deemed dividend than if the lower-tier CFC had paid a dividend to its parent CFC and parent had paid a dividend to the United States shareholder. For example, if the lower-tier CFC paid a large amount of foreign taxes and the parent CFC has paid no foreign taxes but has significant earnings

---

5 Section 904(a).

6 For these purposes, United States property generally includes tangible property located in the U.S., stock of certain related U.S. corporations, obligations of certain related U.S. persons, an obligation of certain related U.S. persons of which a CFC is pledgor or guarantor, a right to use in the U.S. a patent or copyright, an invention, model, or design (whether or not patented), a secret formula or process or any similar property right, acquired or developed by the CFC for use in the U.S., and an interest in United States property owned by a partnership to the extent of the partner CFC's interest in the partnership. See generally section 956.

7 Section 951(a)(1)(B), referencing section 956.

and profits, the United States shareholder would receive more foreign tax credits under pre-Act law by causing the lower-tier CFC to invest in United States property than if it had declared a dividend (because the dividend would flow through the upper-tier subsidiary). The Act would limit the amount of foreign tax credits that may be claimed with respect to a deemed dividend under section 956 to the amount that would have been allowed if a dividend was distributed through the chain of ownership (*i.e.,* from the lower-tier CFC to the upper-tier CFC in the example). This provision applies to the affirmative use of section 956 after the date of enactment.

E. **Repeal of 80/20 company rules; interest paid by resident alien individuals.** Dividends and interest paid by a U.S. person to foreign persons are generally subject to a 30% gross basis withholding tax (subject to the broad portfolio interest exemption). Under pre-Act law, a percentage of the dividends and interest paid by domestic corporations that derive at least 80% of their gross income from the active conduct of a foreign trade or business (referred to as "active foreign business income") during a three-year testing period (which is generally the three year period ending with the close of the taxable year of the corporation preceding the payment) is not subject to U.S. withholding.[8] These companies are referred to as "80/20" companies. Under pre-Act law, interest paid by 80/20 companies is foreign sourced, whereas dividends paid by 80/20 companies are U.S. sourced but not subject to U.S. withholding.[9] The Act repeals the "80/20 company" exception and, accordingly, dividends and interest paid by 80/20 companies to foreign persons will be U.S. sourced and subject to U.S. withholding.[10] The repeal applies to taxable years beginning in 2011. However, under a grandfather provision, payments of interest to foreign persons on debt obligations that were issued before the date of enactment will not be subject to U.S. withholding if they were not subject to withholding before enactment.[11] In addition, under a second grandfather provision, the full amount of a dividend or interest payment will not be subject to U.S. withholding if made by a domestic corporation that (i) was an 80/20 company before enactment, (ii) would remain an 80/20 company in each taxable year after enactment if the corporation and all of its subsidiaries (including

[8] Section 861(a)(1)(A); section 871(i)(2)(B); section 881(d); section 1441(c)(10); section 1442(a).

[9] Section 861(a)(1)(A) (interest sourcing); section 861(a)(2)(A) (dividend sourcing).

[10] In addition, the Act repeals the similar exception for interest paid by resident alien individuals.

[11] An interest payment by a corporation that satisfies this grandfather provision will be U.S. sourced for other tax purposes, such as the foreign tax credit limitation.

foreign subsidiaries) were treated as one corporation, and (iii) has not added a substantial line of business after enactment.[12]

F. **Modification of affiliation rules for interest allocation purposes.** The ability of a U.S. taxpayer to use foreign tax credits is limited by the amount of foreign income earned by the U.S. taxpayer. To prevent U.S. affiliated groups from reducing their foreign-source interest expense by placing debt with foreign subsidiaries that are not members of the affiliated groups, temporary Treasury regulations provide that a foreign corporation is treated as a member of an affiliated group for purposes of determining and apportioning the affiliated group's interest expense if at least 80% of its outstanding stock, by vote or value, is owned by members of the affiliated group and more than 50% of its gross income for the taxable year is effectively connected with the conduct of a U.S. trade or business.[13] However, under a specific rule in the temporary Treasury regulations, if between 50% and 80% of the foreign subsidiary's gross income is effectively connected with the conduct of a U.S. trade or business, then only the assets of the corporation that generate effectively connected income and a corresponding percentage of its interest expense are included in the affiliated group. The Act codifies the general rule contained in the temporary Treasury regulations but eliminates the special rule for foreign subsidiaries with between 50% and 80% of their gross income effectively connected with the conduct of a U.S. trade or business. Accordingly, if a foreign subsidiary is treated as a member of an affiliated group, then all of its assets and debt will be included in the affiliated group. The provision is effective for all taxable years beginning after the date of enactment.

G. **Prevent the avoidance of withholding tax on repatriations of earnings of a foreign subsidiary corporation to a foreign parent corporation where a U.S. corporation is the direct parent of the foreign subsidiary.** Under pre-Act section 304, if a person redeems stock from a related person, the redemption is generally treated as a dividend to the extent of the earnings and profits of both the acquirer and acquired corporations. Thus, under pre-Act section 304, if a foreign corporation sells stock in its U.S. subsidiary to the U.S. subsidiary's foreign subsidiary, any cash received by the foreign parent is treated as a dividend from the foreign subsidiary that is not subject to U.S. withholding tax to the extent of the foreign subsidiary's earnings and profits. Under pre-Act law, if the cash received by the foreign parent in the sale exceeds the foreign subsidiary's earnings and profits, the excess is treated as a dividend paid from the U.S. subsidiary to the

[12] The Act provides transition rules for testing periods that include taxable years before January 1, 2011.

[13] See temporary Treasury regulations section 1.861-11T.

foreign parent, and is subject to U.S. withholding tax (unless the withholding tax is eliminated by a treaty). As a result, under pre-Act law, certain foreign parents could effectively repatriate cash from their U.S. subsidiaries without being subject to U.S. tax.

The Act prevents these tax-free repatriations by amending section 304 to provide that none of the earnings and profits of an acquiring foreign company is taken into account in determining the amount of U.S.-source dividend income that arises from the sale of a U.S. subsidiary to a related foreign acquirer if more than 50% of the dividends arising from the transaction (determined without regard to the new rule) would (i) not be subject to U.S. corporate tax during the tax year the dividends arise, or (ii) not be includable in the earnings and profits of a CFC. This change prevents the cash received by a foreign corporation upon the sale of stock of a U.S. subsidiary to the U.S. subsidiary's foreign subsidiary from being treated as a tax-free foreign dividend and, instead, provides that the cash is treated as a U.S. source dividend subject to U.S. withholding tax to the extent of the U.S. subsidiary's earnings and profits. The provision applies to acquisitions after the date of enactment.

* * * *

If you have any questions regarding this memorandum, please contact any member of the Cadwalader Tax Department.