TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF H.R. 5982, THE "SMALL BUSINESS TAX RELIEF ACT OF 2010"

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of the
JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions of H.R. 5982, the "Small Business Tax Relief Act of 2010." Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 5982, the "Small Business Tax Relief Act of 2010,"* (JCX-43-10), July 30, 2010. This document can also be found on our website at www.jct.gov.

TITLE I − REPEAL OF CERTAIN INFORMATION REPORTING REQUIREMENTS

A. Repeal of Expansion of Certain Information Reporting Requirements to Corporations and to Payments for Property (sec. 101 of the bill and sec. 6041(h) of the Code)

Present Law

A variety of information reporting requirements apply under present law.[2] The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments to any one payee aggregating $600 or more in any taxable year in the course of that payor's trade or business.[3] Reportable payments include compensation for both goods and services, and may include gross proceeds. Certain enumerated types of payments that are subject to other specific reporting requirements are carved out of reporting under this general rule by regulation.[4]

One such carveout excepts payments to corporations, but was expressly overridden by the addition of new section 6041(h) by section 9006 of the Patient Protection and Affordable Care Act.[5] That section expanded information reporting requirements to include gross proceeds paid in consideration for property and to subject corporations to all of the reporting requirements under section 6041 of the Code. The payor is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.[6] The regulations generally except from reporting payments to exempt organizations, governmental entities, international organizations, or retirement plans. Additionally, the requirement that businesses report certain payments is not applicable to persons engaged in a passive investment activity.

[2] Secs. 6031 through 6060.

[3] Sec. 6041(a). Information returns are generally submitted electronically on Forms 1096 and Forms 1099, although certain payments to beneficiaries or employees may require use of Forms W-3 and W-2, respectively. Treas. Reg. sec. 1.6041-1(a)(2).

[4] Sec. 6041(a) requires reporting "other than payments to which section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a) or 6050N(a) applies and other than payments with respect to which a statement is required under authority of section 6042(a), 6044(a)(2) or 6045[.]" The payments thus excepted include most interest, royalties, and dividends.

[5] Treas. Reg. sec. 1.6041-3(p); P.L. No. 111-148.

[6] Sec. 6041(d). Specifically, the recipient of the payment is required to provide a Form W-9 to the payor, which enables the payee to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor. If a Form W-9 is not provided, the payor is required to "backup withhold" tax at a rate of 28 percent of the gross amount of the payment unless the payee has otherwise established that the income is exempt from backup withholding. The backup withholding tax may be credited by the payee against regular income tax liability, i.e., it is effectively an advance payment of tax, similar to the withholding of tax from wages. This combination of reporting and backup withholding is designed to ensure that U.S. persons pay an appropriate amount of tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

Failure to comply with the information reporting requirements results in penalties, which may include a penalty for failure to file the information return,[7] and a penalty for failure to furnish payee statements[8] or failure to comply with other various reporting requirements.[9]

Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock).[10] In general, the requirement to file Form 1099 applies with respect to amounts paid to U.S. persons and is linked to the backup withholding rules of section 3406. Thus, a payor of interest, dividends or gross proceeds generally must request that a U.S. payee (other than certain exempt recipients) furnish a Form W-9 providing that person's name and taxpayer identification number.[11] That information is then used to complete the Form 1099.

Explanation of Provision

Under the provision, Section 9006 of the Patient Protection and Affordable Care Act is repealed in its entirety.

[7] Sec. 6721. The penalty for the failure to file an information return generally is $50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed $250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

[8] Sec. 6722. The penalty for failure to provide a correct payee statement is $50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed $100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

[9] Sec. 6723. The penalty for failure to timely comply with a specified information reporting requirement is $50 per failure, not to exceed $100,000 for a calendar year.

[10] Secs. 6042 (dividends), 6045 (broker reporting) and 6049 (interest) and the Treasury regulations thereunder.

[11] See Treas. Reg. sec. 31.3406(h)-3.

TITLE II − REVENUE PROVISIONS

A. Foreign Provisions

1. Rules to prevent splitting foreign tax credits from the income to which they relate (sec. 201 of the bill and new sec. 909 of the Code)

<u>**Present Law**</u>

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Subject to the limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays or accrues. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the foreign corporation's earnings are distributed or included in the domestic corporation's income under the provisions of subpart F.[12]

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes.[13] Other foreign levies generally are treated as deductible expenses. Treasury regulations under section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax.

The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.[14]

<u>**Deemed-paid foreign tax credit**</u>

Domestic corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder.[15] This credit is the deemed-paid or indirect foreign tax credit. A domestic corporation may also be deemed to have paid taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.[16] Foreign taxes paid below the third tier are eligible for the deemed-paid credit only

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[12] Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

[13] Secs. 901(b), 903.

[14] Sec. 164(a)(3).

[15] Sec. 902(a).

[16] Sec. 902(b).

with respect to taxes paid in taxable years during which the payor is a controlled foreign corporation ("CFC"). Foreign taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to subpart F inclusions and inclusions under the PFIC provisions.[17]

The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and is included in the domestic corporate shareholder's income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation.[18]

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation's accumulated earnings and profits.[19] Accumulated earnings and profits for this purpose include the earnings and profits of the current year undiminished by the current distribution (or other inclusion).[20] Dividends in excess of the pool of post-1986 undistributed earnings and profits are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.[21]

<u>Foreign tax credit limitation</u>

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).[22] This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding 10 taxable years.[23]

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[17] Secs. 960(a), 1291(g), 1293(f).

[18] Sec. 78.

[19] Sec. 902(c)(6)(B). Earnings and profits computations for these purposes are to be made under U.S. concepts. Secs. 902(c)(1), 964(a).

[20] Sec. 902(c)(1).

[21] Sec. 902(c)(6).

[22] Secs. 901, 904.

[23] Sec. 904(c).

The foreign tax credit limitation is generally applied separately for income in two different categories (referred to as "baskets"), passive basket income and general basket income.[24] Passive basket income generally includes investment income such as dividends, interest, rents, and royalties.[25] General basket income is all income that is not in the passive basket. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one basket cannot be used to offset U.S. tax on income in the other basket.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).[26] Passive income is also treated as general basket income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as applicable).[27] Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least 10 percent of the CFC are assigned to a separate limitation basket by reference to the basket of income out of which the dividend or other payment is made.[28] Dividends received by a 10-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.[29]

Explanation of Provision

The provision adopts a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. In general, the provision states that when there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by the taxpayer, such tax is not taken into account for purposes of the Code before the taxable year in which the related income is taken into account by the taxpayer under chapter 1 of the Code. In addition, if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a section 902 corporation, that tax is not taken into account for purposes of section 902 or 960, or for purposes of determining earnings and profits under section 964(a), before the taxable year in which the related income is taken into account under chapter 1 of the Code by the section 902

[24] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., secs. 901(j), 904(h)(10), 865(h).

[25] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

[26] Sec. 904(d)(2)(C), (D).

[27] Sec. 904(d)(2)(F).

[28] Sec. 904(d)(3).

[29] Sec. 904(d)(4).

corporation, or a domestic corporation that meets the ownership requirements of section 902(a) or (b) with respect to the section 902 corporation. Thus, such tax is not added to the section 902 corporation's foreign tax pool, and its earnings and profits are not reduced by such tax.

In the case of a partnership, the provision's matching rule is applied at the partner level, and, except as otherwise provided by the Secretary, a similar rule applies in the case of any S corporation or trust. The Secretary may also issue regulations to establish the applicability of this matching rule to a regulated investment company that elects under section 853 for the foreign income taxes it pays to be treated as creditable to its shareholders under section 901.

For purposes of the provision, there is a "foreign tax credit splitting event" with respect to a foreign income tax if the related income is (or will be) taken into account under chapter 1 of the Code by a covered person.[30] A "foreign income tax" is any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States. This term includes any tax paid in lieu of such a tax within the meaning of section 903. "Related income" means, with respect to any portion of any foreign income tax, the income (or, as appropriate, earnings and profits), calculated under U.S. tax principles, to which such portion of foreign income tax relates. For purposes of determining related income, the Secretary may provide rules on the treatment of losses, deficits in earnings and profits, and certain timing differences between U.S. and foreign tax law. Moreover, it is not intended that differences in the timing of when income is taken into account for U.S. and foreign tax purposes (e.g., as a result of differences in the U.S. and foreign tax accounting rules) should create a foreign tax credit splitting event in cases in which the same person pays the foreign tax and takes into account the related income, but in different taxable periods.

With respect to any person who pays or accrues a foreign income tax (hereafter referred to in this paragraph as the "payor"), a "covered person" is: (1) any entity in which the payor holds, directly or indirectly, at least a 10-percent ownership interest (determined by vote or value); (2) any person that holds, directly or indirectly, at least a 10-percent ownership interest (determined by vote or value) in the payor; (3) any person that bears a relationship to the payor described in section 267(b) or 707(b) (including by application of the constructive ownership rules of section 267(c)); and (4) any other person specified by the Secretary. Accordingly, the Secretary may issue regulations that treat an unrelated counterparty as a covered person in certain sale-repurchase transactions and certain other transactions deemed abusive.

A "section 902 corporation" is any foreign corporation with respect to which one or more domestic corporations meets the ownership requirements of section 902(a) or (b).

Except as otherwise provided by the Secretary, in the case of any foreign income tax not currently taken into account by reason of the provision's matching rule, such tax is taken into account as a foreign income tax paid or accrued in the taxable year in which, and to the extent

[30] It is not intended that there be a foreign tax credit splitting event when, for example, a CFC pays or accrues a foreign income tax and takes into account the related income in the same year, even though the earnings and profits to which the foreign income tax relates may be distributed to a covered person as a dividend or included in such covered person's income under subpart F.

that, the taxpayer, the section 902 corporation, or a domestic corporation that meets the ownership requirements of section 902(a) or (b) with respect to the section 902 corporation (as the case may be) takes the related income into account under chapter 1 of the Code. Accordingly, for purposes of determining the carryback and carryover of excess foreign tax credits under section 904(c), the deduction for foreign taxes paid or accrued under section 164(a), and the extended period for claim of a credit or refund under section 6511(d)(3)(A), foreign income taxes to which the provision applies will first be taken into account, and treated as paid or accrued, in the year in which the related foreign income is taken into account. Notwithstanding the preceding rule, foreign taxes are translated into U.S. dollars in the year in which the taxes are paid or accrued under the general rules of section 986 rather than the year in which the related income is taken into account. The Secretary may issue regulations or other guidance providing additional exceptions.

The Secretary is also granted authority to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of the provision. Such guidance may include providing successor rules addressing circumstances such as where, with respect to a foreign tax credit splitting event, the person who pays or accrues the foreign income tax or any covered person is liquidated. This grant of authority also allows the Secretary to provide appropriate exceptions from the application of the provision as well as to provide guidance as to how the provision applies in the case of any foreign tax credit splitting event involving a hybrid instrument. It is anticipated that the Secretary may also provide guidance as to the proper application of the provision in cases involving disregarded payments, group relief, or other arrangements having a similar effect.

An example of a foreign tax credit splitting event involving a hybrid instrument subject to the provision is as follows. U.S. Corp., a domestic corporation, wholly owns CFC1, a country A corporation. CFC1, in turn, wholly owns CFC2, a country A corporation. CFC2 is engaged in an active business that generates $100 of income. CFC2 issues a hybrid instrument to CFC1. This instrument is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. Under the terms of the hybrid instrument, CFC2 accrues (but does not pay currently) interest to CFC1 equal to $100. As a result, CFC2 has no income for country A tax purposes, while CFC1 has $100 of income, which is subject to country A tax at a 30 percent rate. For U.S. tax purposes, CFC2 still has $100 of earnings and profits (the accrued interest is ignored since the United States views the hybrid instrument as equity), while CFC1 has paid $30 of foreign taxes. Under the provision, the related income with respect to the $30 of foreign taxes paid by CFC1 is the $100 of earnings and profits of CFC2.

Effective Date

In general, the provision is effective with respect to foreign income taxes paid or accrued by U.S. taxpayers and section 902 corporations after December 31, 2010.

The provision also applies to foreign income taxes paid or accrued by a section 902 corporation on or before December 31, 2010 (and not deemed paid under section 902(a) or 960 on or before such date), but only for purposes of applying sections 902 and 960 with respect to periods after such date (the "deemed-paid transition rule"). Accordingly, such rule applies for purposes of applying section 902 and 960 to dividends paid, and inclusions under section 951(a) that occur, after December 31, 2010. However, no adjustment is made to a section 902 corporation's earnings and profits for the amount of any foreign income taxes suspended under the deemed-paid transition rule, either at the time of suspension or when such taxes are subsequently taken into account under the provision.

2. Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions (sec. 202 of the bill and new sec. 901(m) of the Code)

Present Law

Foreign Tax Credit

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Subject to the limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or is included in the domestic corporation's income under the provisions of subpart F.[31]

The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.[32]

Deemed-paid foreign tax credit

U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's E&P become subject to U.S. tax as dividend income of the U.S. shareholder.[33] This credit is the "deemed-paid" or "indirect" foreign tax credit. A U.S. corporation may also be deemed to have paid foreign income taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.[34] Foreign income taxes paid below the third tier are eligible for the deemed-paid credit only with respect to foreign income taxes paid in taxable years during which the payor is a controlled foreign corporation ("CFC"). Foreign income taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to

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[31] Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

[32] Sec. 164(a)(3).

[33] Sec. 902(a).

[34] Sec. 902(b).

subpart F inclusions.[35] Moreover, a deemed-paid credit generally is available with respect to inclusions under the PFIC provisions by U.S. corporations meeting the requisite ownership threshold.[36]

The amount of foreign income tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and is included in the U.S. corporate shareholder's income; accordingly, the shareholder is treated as if it had received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign income tax paid by the foreign corporation.[37]

For purposes of computing the deemed-paid foreign tax credit, dividends (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation's accumulated E&P.[38] Accumulated E&P for this purpose include the E&P of the current year undiminished by the current distribution (or other inclusion).[39] Dividends in excess of the accumulated pool of post-1986 undistributed E&P are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.[40]

Foreign tax credit limitation

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).[41] This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry the excess back to the previous taxable year or forward to one of the succeeding 10 taxable years.[42]

[35] Sec. 960(a).

[36] Secs. 1291(g), 1293(f).

[37] Sec. 78.

[38] Sec. 902(c)(6)(B). Earnings and profits computations for these purposes are to be made under U.S. concepts. Secs. 902(c)(1), 964(a).

[39] Sec. 902(c)(1).

[40] Sec. 902(c)(6).

[41] Secs. 901, 904.

[42] Sec. 904(c).

The foreign tax credit limitation is generally applied separately to two different categories of income (referred to as "baskets"), passive basket income and general basket income.[43] Passive basket income generally includes investment income such as dividends, interest, rents, and royalties.[44] General basket income is all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, foreign tax imposed on income in one basket cannot be claimed as a credit against U.S. tax on income in the other basket.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).[45] Passive income is also treated as general basket income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as applicable).[46] Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least 10 percent of the CFC are assigned to a separate limitation basket by reference to the basket of income out of which the dividend or other payment is made.[47] Dividends received by a 10-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.[48]

Items Giving Rise to Permanent Basis Differences

In general, certain elections or transactions can result in the creation of additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the basis of such assets for foreign tax purposes. These include: (1) a qualifying stock purchase of a foreign corporation or domestic corporation with foreign assets for which a section 338 election is made; (2) an acquisition of an interest in a partnership holding foreign assets for which a section 754 election is in effect; and (3) certain other transactions involving an entity classification ("check-the-box") election in which a foreign entity is treated as a corporation for foreign tax purposes and as a partnership or disregarded entity for U.S. tax purposes.[49]

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[43] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., secs. 901(j), 904(h)(10), 865(h).

[44] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

[45] Sec. 904(d)(2)(C), (D).

[46] Sec. 904(d)(2)(F).

[47] Sec. 904(d)(3).

[48] Sec. 904(d)(4).

[49] Treas. Reg. sec. 301.7701-1, *et seq.*

Section 338 elections

In general, the basis of stock acquired by a U.S. taxpayer or a foreign subsidiary of a U.S. taxpayer is its cost,[50]and there is no adjustment to the basis of the assets held by the acquired corporation.[51] In certain circumstances, however, taxpayers may elect to treat a qualifying purchase of 80 percent of the stock of a target corporation (a "qualified stock purchase") as a purchase of the underlying assets of the target corporation.[52] For this purpose, a "qualified stock purchase" is any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of one corporation is acquired by another corporation by purchase during the 12-month acquisition period.[53]

Two alternatives exist for making a section 338 election when there is a qualifying stock purchase—one bilateral and one unilateral. A bilateral election, which is made pursuant to section 338(h)(10), requires a corporation to make a qualifying purchase of 80 percent of the stock of a domestic target corporation[54] that is a member of a selling consolidated group (or affiliated group if no election to file a consolidated return has been made), or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders. The election is made jointly by the buyer and seller of the stock and must be made by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. Pursuant to this election, the assets (rather than the stock) of the target corporation are deemed to have been sold in a single transaction at the close of the acquisition date, and the target corporation is deemed to have liquidated. The asset sale is taken into account by the target prior to its acquisition by the purchasing corporation.[55]

With a unilateral election, which is made pursuant to section 338(g), the purchasing corporation treats a qualified stock purchase of a corporation (including a foreign corporation) as a deemed asset acquisition, whether or not the seller of the stock is a corporation. Pursuant to this election, the seller or sellers recognize gain or loss on the stock sale, and the target corporation also recognizes gain or loss on the deemed asset sale. The deemed asset acquisition

[50] Secs. 1011, 1012.

[51] See sec. 1016.

[52] Sec. 338(a).

[53] Sec. 338(d)(3). Under section 1504(a)(2), the ownership of stock of any corporation meets the requirements of an affiliated group if it (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and (B) has a value equal to at least 80 percent of the total value of the stock of such corporation. Further, section 1504(a)(4) states that for purposes of meeting the 80-percent requirement, the term stock does not include any stock which (A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which do not exceed the issue price of such stock, and (D) is not convertible into another class of stock.

[54] A foreign corporation cannot be the target corporation in the case of a section 338(h)(10) election. See Treas. Reg. sec. 1.338(h)(10)-1(b)(1), (2), (3).

[55] Sec. 338(h)(10); Treas. Regs. sec. 1.338(h)(10)-1(d)(3).

also eliminates the historic E&P of the target corporation. In general, in cases in which the target corporation is foreign and the seller is a U.S. person or a CFC, the deemed asset sale has U.S. tax consequences.[56] However, when the seller is neither a U.S. person nor a CFC, generally no U.S. tax consequences result from the deemed asset sale.[57] The election is made by the purchasing corporation and must be made by the 15th day of the ninth month beginning after the month in which the acquisition date occurs.

Pursuant to a section 338 election, the target corporation is treated as (1) having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and (2) a new corporation that purchased all of the assets as of the beginning of the day after the acquisition date.[58] Accordingly, the aggregate basis of the assets of the target equals the sum of (1) the grossed-up basis of the purchasing corporation's recently purchased stock, and (2) the basis of the purchasing corporation's nonrecently purchased stock, with appropriate adjustments for liabilities and other relevant items under the regulations.[59]

Since a section 338 election is relevant solely for U.S. tax purposes, the adjustment to the basis of the assets of a foreign target corporation (or a foreign branch of a domestic corporation) that increases the amount of depreciation, amortization, depletion, or gain for purposes of calculating U.S. taxable income or E&P results in no corresponding adjustment for foreign income tax purposes. As a result, cost recovery deductions attributable to such additional basis generally result in a permanent difference between (1) the foreign taxable income upon which foreign income tax is levied, and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed for any foreign income taxes paid.

Section 754 election

A partnership does not generally adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 for such purposes.[60] If an election is in effect, adjustments to the basis of partnership

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[56] Section 338(h)(16) addresses the impact of the deemed asset sale on the E&P of the foreign target corporation for purposes of determining the source and character of any amount includible in gross income as a dividend under section 1248 to the seller.

[57] When a domestic corporation or a CFC is the purchaser with respect to which a section 338(g) election is made for a foreign target corporation, the deemed asset sale may have U.S. tax consequences. For example, if the foreign target becomes a CFC for an uninterrupted period of 30 days or more during a taxable year pursuant to Section 951(a) prior to the purchasing corporation completing the qualified stock purchase, the deemed asset sale may generate subpart F income for any U.S. shareholder of the foreign target corporation. Treas. Reg. sec. 1.338-9(b).

[58] Sec. 338(a).

[59] Sec. 338(b).

[60] Sec. 743(a). But see section 743(d) requiring a reduction to the basis of partnership property in certain cases where there is a substantial built-in loss.

property are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[61] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Since a section 754 election has relevance only for U.S. tax purposes, to the extent that the underlying assets of the partnership include assets generating income subject to foreign tax, the basis adjustments made to these assets may also result in permanent differences between (1) the foreign taxable income upon which foreign income tax is levied, and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed for any foreign income taxes paid.

Check-the-box election

Comparable permanent differences between foreign taxable income and U.S. taxable income (or E&P) may also be achieved as a result of making a check-the-box election. Since a check-the-box election generally has no effect for foreign tax purposes, a sale of a wholly-owned foreign corporation for which an election to be disregarded is in effect will be respected as the sale of the corporation for foreign tax purposes but treated as the sale of branch assets for U.S. tax purposes. If the purchaser is a U.S. taxpayer or a foreign entity owned by a U.S. taxpayer, the U.S. taxpayer may have additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the tax basis of such assets for foreign tax purposes. In this case, there would be a permanent difference between (1) the foreign taxable income upon which foreign income tax is levied, and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed. Similar results may be achieved through other transactions in which a check-the-box election has been made.

Explanation of Provision

The provision denies a credit for the disqualified portion of any foreign income tax paid or accrued in connection with a covered asset acquisition.

A "covered asset acquisition" means: (1) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies;[62] (2) any transaction that is treated as the acquisition of assets for U.S. tax purposes and as the acquisition of stock (or is disregarded)[63] for purposes of the foreign income taxes of the relevant jurisdiction;[64] (3) any acquisition of an

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[61] Sec. 743(b).

[62] This includes transaction under section 338(g) and section 338(h)(10).

[63] For example, the deemed liquidation of a CFC as the result of the making of an entity classification election pursuant to Treas. Reg. sec. 301.7701-3 may result in a section 331 liquidation for U.S. tax purposes that is disregarded for foreign income tax purposes.

[64] Section 336(e) provides that, to the extent provided by the Secretary, in cases in which (1) a corporation owns at least 80 percent of the vote and value of stock of another corporation (as defined in section 1504(a)(2)), and (2) such corporation sells, exchanges, or distributes all of stock of such corporation, an election may be made to treat

interest in a partnership that has an election in effect under section 754; and (4) to the extent provided by the Secretary, any other similar transaction. It is anticipated that the Secretary will issue regulations identifying other similar transactions that result in an increase to the basis of assets for U.S. tax purposes without a corresponding increase for foreign tax purposes.

The disqualified portion of any foreign income taxes paid or accrued with respect to any covered asset acquisition, for any taxable year, is the ratio (expressed as a percentage) of (1) the aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets, divided by (2) the income on which the foreign income tax is determined. For this purpose, the income on which the foreign income tax is determined is the income as determined under the law of the relevant jurisdiction. If the taxpayer fails to substantiate such income to the satisfaction of the Secretary, then such income is determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction.

For purposes of determining the aggregate basis difference allocable to a taxable year, the term "basis difference" means, with respect to any relevant foreign asset, the excess of (1) the adjusted basis of such asset immediately after the covered asset acquisition, over (2) the adjusted basis of such asset immediately before the covered asset acquisition. Thus, it is the tax basis for U.S. tax purposes that is relevant, and not the basis as determined under the law of the relevant jurisdiction. Because CFCs are generally limited to straight-line cost recovery, it is anticipated that the basis difference applying U.S. tax principles will generally be less than if the taxpayer were required to use the basis as determined under foreign law immediately before the covered asset acquisition. However, it is anticipated that the Secretary will issue regulations identifying those circumstances in which, for purposes of determining the adjusted basis of such assets immediately before the covered asset acquisition, it may be acceptable to utilize the basis of such asset under the law of the relevant jurisdiction or another reasonable method.

A built-in loss in a relevant foreign asset (i.e., in cases in which the fair market value of the asset is less than its adjusted basis immediately before the asset acquisition) is taken into account in determining the aggregate basis difference; however, a built-in loss cannot reduce the aggregate basis difference allocable to a taxable year below zero.

In the case of a qualified stock purchase to which section 338(a) applies, the covered asset acquisition is treated as occurring at the close of the acquisition date (as defined in section 338(h)(2)).

In general, the amount of the basis difference allocable to a taxable year with respect to any relevant foreign asset is determined using the applicable cost recovery method under U.S. tax rules. If there is a disposition of any relevant foreign asset before its cost has been entirely

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this sale, exchange, or distribution as a disposition of all of the assets of the other corporation, and no gain or loss is recognized on the sale, exchange, or distribution of the stock. To date, the Secretary has not promulgated regulations under section 336(e) so no election may be made. Nonetheless, to the extent regulations are promulgated under section 336(e) in the future permitting such an election to be made, a transaction to which the section 336(e) election relates would be a covered asset acquisition.

recovered or of any relevant foreign asset that is not eligible for cost recovery (e.g., land), the basis difference allocated to the taxable year of the disposition is the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset that has been allocated under this provision to all prior taxable years. Thus, any remaining basis difference is captured in the year of the sale, and there is no remaining basis difference to be allocated to any subsequent tax years. However, it is intended that this provision generally apply in circumstances in which there is a disposition of a relevant foreign asset where the associated income or gain is taken into account for purposes of determining foreign income tax in the relevant jurisdiction.

To illustrate, assume USP, a domestic corporation, acquires 100 percent of the stock of FT, a foreign target organized in Country F with a "u" functional currency, in a qualified stock purchase for which a section 338(g) election is made. The tax rate in Country F is 25 percent. Assume further that the aggregate basis difference in connection with the qualified stock purchase is 200u, including: (1) 150u that is attributable to Asset A, with a 15-year recovery period for U.S. tax purposes (10u of annual amortization); and (2) 50u that is attributable to Asset B, with a 5-year recovery period (10u of annual depreciation). In each of years 1 and 2, FT's taxable income is 100u for local tax purposes and FT pays foreign income tax of 25u (equal to $25 when translated at the average exchange rate for the year). As a result, the disqualified portion of foreign income tax in each of years 1 and 2 is $5 ((10u + 10u of allocable basis difference / 100u of foreign taxable income) x $25 foreign tax paid).

In year 3, FT's taxable income is 140u, 40u of which is attributable to gain on the sale of Asset B. FT's Country F tax is 35u (equal to $35 translated at the average exchange rate for the year). Accordingly, the disqualified portion of its foreign income taxes paid is $10 ((40u (including 10u of annual amortization on Asset A and 30u attributable to disposition of Asset B) of allocable basis difference / 140u of foreign taxable income) x $35 foreign tax paid).

An asset is a "relevant foreign asset" with respect to any covered asset acquisition, whether the entity acquired is domestic or foreign, only if any income, deduction, gain, or loss attributable to such asset (including goodwill, going concern value, and any other intangible asset) is taken into account in determining foreign income tax in the relevant jurisdiction. For this purpose, the term "foreign income tax" means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States, including any tax paid in lieu of such a tax within the meaning of section 903. In cases in which there has been a covered asset acquisition that involves either (1) both U.S. assets and relevant foreign assets, or (2) assets in multiple relevant jurisdictions, it is anticipated that the Secretary may issue regulations clarifying the manner in which any relevant foreign asset (such as intangible assets that may relate to more than one jurisdiction) will be allocated between those jurisdictions. It is also anticipated that the Secretary may issue regulations to clarify the extent to which income is considered attributable to a relevant foreign asset, as well as the treatment of an asset that ceases to be taken into account in determining the foreign income tax in the relevant jurisdiction by some mechanism other than a disposition.

To the extent that a foreign tax credit is disallowed, the disqualified portion is allowed as a deduction to the extent otherwise deductible.[65]

The Secretary may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of this provision, including to provide (1) an exemption for certain covered asset acquisitions, and (2) an exemption for relevant foreign assets with respect to which the basis difference is de minimis. For example, it is anticipated that the Secretary will exclude covered asset acquisitions that are not taxable for U.S. purposes, or in which the basis of the relevant foreign assets is also increased for purposes of the tax laws of the relevant jurisdiction.

Effective Date

In general, the provision is effective for covered asset acquisitions after December 31, 2010. However, the provision does not apply to any covered asset acquisition with respect to which the transferor and transferee are not related if such acquisition is (1) made pursuant to a written agreement that was binding on May 20, 2010, and at all times thereafter, (2) described in a ruling request[66] submitted to the IRS on or before such date, or (3) described in a public announcement or filing with the SEC on or before such date.

For this purpose, a person shall be treated as related to another person if the relationship between such persons is described in sections 267 or 707(b).

3. Separate application of foreign tax credit limitation, etc., to items resourced under treaties (sec. 203 of the bill and sec. 904(d) of the Code)

Present Law

The United States taxes its citizens and residents (including domestic corporations) on worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. Subject to limitations discussed below, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for foreign income taxes paid or accrued.[67] A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the foreign corporation's earnings are distributed or included in the domestic corporation's income under the provisions of subpart F.[68]

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[65] Sec. 164(a)(3).

[66] A private letter ruling may be relied upon only by the taxpayer requesting the ruling. Transition relief is available only with respect to the transaction for which the ruling is requested.

[67] Sec. 901.

[68] Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes.[69] Other foreign levies generally are treated as deductible expenses. The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.[70]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).[71] This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding 10 taxable years.[72]

The foreign tax credit limitation is generally applied separately for income in two different categories (referred to as "baskets"), passive category income and general category income.[73] Passive category income generally includes investment income such as dividends, interest, rents, and royalties.[74] General category income is all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one basket cannot be used to offset U.S. tax on income in the other basket.

Income that would otherwise constitute passive basket income is treated as general basket income if it is earned by a qualifying financial services entity (and certain other requirements are met).[75] Passive income is also treated as general basket income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as

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[69] Secs. 901(b), 903.

[70] Sec. 164(a)(3).

[71] Secs. 901, 904.

[72] Sec. 904(c).

[73] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., secs. 901(j), 904(h)(10), 865(h).

[74] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

[75] Sec. 904(d)(2)(C), (D).

applicable).[76] Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person that owns at least 10 percent of the CFC are assigned to a separate basket by reference to the basket of income out of which the dividend or other payment is made.[77] Dividends received by a 10-percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.[78]

In general, amounts derived from a foreign corporation (such as interest and dividends) are treated as foreign-source income for U.S. foreign tax credit limitation purposes. A special sourcing rule applies to amounts (such as interest and dividends) derived from a U.S.-owned foreign corporation that are attributable to U.S.-source income of the foreign corporation. This special sourcing rule treats such amounts, which would otherwise be treated as foreign source, as U.S. source.[79] For these purposes, a U.S.-owned foreign corporation is a foreign corporation that is at least 50-percent owned (directly or in certain cases indirectly) by vote or value by U.S. persons. The effect of sourcing what under the general rules would be foreign-source income as U.S.-source income under these special rules is to prevent taxpayers from routing U.S.-source income through a foreign affiliate to increase the taxpayer's foreign-source income and, therefore, the taxpayer's foreign tax credit limitation.

A coordination rule applies in the case of an amount that would be treated as U.S.-source income under the special sourcing rule but which is treated as foreign source under a treaty. If (1) any amount derived from a U.S.-owned foreign corporation would be treated as U.S-source income under the special sourcing rule described above, (2) a U.S. treaty obligation would treat such income as arising from sources outside the United States, and (3) the taxpayer chooses the benefits of this coordination rule, then the amount will be treated as foreign source. However, for foreign tax credit limitation purposes, a separate limitation applies to such amount and the associated foreign taxes. This coordination rule applies only to amounts derived from a U.S.-owned foreign corporation, and not to amounts derived from a foreign branch or disregarded entity.

For gains from the sale of certain stock or intangibles, a similar special sourcing rule applies to treat any such gain as foreign source, while requiring the taxpayer to assign any such gain and associated taxes to a separate limitation category for purposes of computing the foreign tax credit.[80] This rule applies to the gain from sale of stock in a foreign corporation or an

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[76] Sec. 904(d)(2)(F).

[77] Sec. 904(d)(3).

[78] Sec. 904(d)(4).

[79] Sec. 904(h). The special sourcing rule applies in the case of subpart F and passive foreign investment company inclusions to the extent that such amount is attributable to income of the U.S.-owned foreign corporation from U.S. sources; in the case of dividends, to the portion of the U.S.-owned foreign corporation's earnings and profits for the taxable year that are from U.S. sources; and in the case of interest paid to a U.S. shareholder or related person, to amounts properly allocable to the U.S.-owned foreign corporation's U.S.-source income. De minimis exceptions apply if the U.S.-owned foreign corporation has a small amount of U.S.-source income.

[80] Sec. 865(h).

intangible that would be U.S. source but which under a U.S.-treaty obligation is treated as foreign source with respect to which the taxpayer chooses the benefits of this rule. This rule also applies to certain gains derived from a liquidating distribution from certain U.S.-possession corporations.

Explanation of Provision

The provision applies a separate foreign tax credit limitation for each item that (1) would be treated as derived from sources within the United States, (2) would be treated as arising from sources outside the United States under a treaty obligation of the United States, and (3) the taxpayer chooses the benefits of such treaty.

The provision does not apply to items of income to which the coordination rule applicable to U.S.-owned foreign corporations or the rule for gains from the sale of certain stock or intangibles (discussed above) apply. The provision gives the Secretary authority to issue guidance as necessary or appropriate to carry out the purposes of the provision, including guidance providing that related items of income may be aggregated for purposes of the provision or grouping together items of income from the same trade or business.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

4. Limitation on the amount of foreign taxes deemed paid with respect to section 956 inclusions (sec. 204 of the bill and sec. 960 of the Code)

Present Law

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Income earned directly or through a pass-through entity (such as a partnership) is taxed on a current basis. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until such earnings are repatriated to the United States through a distribution of those earnings to the U.S. person. This ability of U.S. persons to defer income is circumscribed by various regimes intended to restrict or eliminate tax deferral with respect to certain categories of passive or highly mobile income. The main anti-deferral regimes are the controlled foreign corporation ("CFC") rules of subpart F[81] and the passive foreign investment company rules.[82]

[81] See secs. 951-964.

[82] See secs. 1291-1298.

The subpart F CFC rules

Under the subpart F CFC rules, a 10 percent-or-greater U.S. shareholder (a "U.S. Shareholder") of a CFC is subject to U.S. tax currently on (1) its pro rata share of certain income earned by the CFC[83] and (2) certain untaxed earnings invested in U.S. property with respect to such shareholder.[84] In each case, the U.S. Shareholder is subject to tax currently, whether or not such income is distributed. A CFC is defined generally as a foreign corporation with respect to which U.S. Shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.[85]

U.S. property held by CFCs

A U.S. Shareholder that owns stock in a CFC on the last day of the taxable year must include in its gross income the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not previously taxed[86]) (a "section 956 inclusion").[87] The section 956 inclusion for any taxable year is generally the lesser of (1) the excess of such shareholder's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter of such taxable year over the amount of previously taxed income from prior section 956 inclusions[88] with respect to such shareholder, or (2) such shareholder's pro rata share of the applicable earnings of such CFC.[89]

Foreign Tax Credits

Subject to the limitations discussed below, a U.S. person is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. As discussed below, a domestic corporation may[90] also be allowed a "deemed-paid" credit for foreign income taxes paid by a foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or is included in the domestic corporation's income under the provisions of subpart F, including section 956 inclusions.[91]

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[83] Sec. 951(a)(1)(A).

[84] Sec. 951(a)(1)(B).

[85] Sec. 957(a).

[86] Sec. 959(a)(2).

[87] Sec. 951(a)(1)(B).

[88] See sec. 959(c)(1)(A).

[89] Sec. 956(a).

[90] A U.S. Shareholder includes individuals and entities. Sec. 951(b). In contrast, only those U.S. Shareholders that are corporations are entitled to the deemed-paid credit.

[91] Secs. 901, 902, 960. Similar rules apply under sections 1291(g) and 1293(f) with respect to income that is includible under the passive foreign investment company ("PFIC") rules.

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. The foreign tax credit is elective on a year-by-year basis. In lieu of electing the foreign tax credit, U.S. persons generally are permitted to deduct foreign taxes.[92]

Deemed-paid foreign tax credit

Domestic corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits ("E&P") become subject to U.S. tax as dividend income of the domestic corporation.[93] This credit is the deemed-paid, or indirect, foreign tax credit. A domestic corporation may also be deemed to have paid taxes paid by a second-, third-, fourth-, fifth-, or sixth-tier foreign corporation, if certain requirements are satisfied.[94] Foreign taxes paid below the third tier are eligible for the deemed-paid credit only with respect to taxes paid in taxable years during which the payor is a CFC and the corporation claiming the credit is a U.S. Shareholder of the CFC.[95] Foreign taxes paid below the sixth tier are not eligible for the deemed-paid credit. In addition, a deemed-paid credit generally is available with respect to any inclusion of subpart F income or investments of earnings in U.S. property for the taxable year.[96] The amount of the credit is determined by the same formula as under section 902, except that the numerator of the ratio is the amount of the inclusion, rather than the amount of dividends received during the taxable year.[97]

E&P is determined under the same rules for purposes of the deemed-paid credit fraction with respect to subpart F and section 956 inclusions as for dividends.[98] These rules generally[99] provide that the E&P of any foreign corporation is determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary. The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and is included in the domestic corporation's income; accordingly, the domestic corporation is treated as if it had

[92] Sec. 164(a)(3).

[93] Sec. 902(a).

[94] Sec. 902(b).

[95] Sec. 902(b)(2).

[96] Sec. 960(a).

[97] Sec. 960(a)(1); Treas. Reg. sec. 1.960-1(i)(1).

[98] See secs. 902(c)(1), 964; Treas. Reg. sec. 1.964-1(a)(1).

[99] For an exception, see sec. 312(k)(4).

received its proportionate share of pre-tax profits of the foreign corporation and paid its proportionate share of the foreign tax paid by the foreign corporation.[100]

For purposes of computing the deemed-paid foreign tax credit, distributions (or other inclusions) are considered made first from the post-1986 pool of all the distributing foreign corporation's accumulated E&P.[101] Accumulated E&P for this purpose includes the E&P of the current year undiminished by the current distribution (or other inclusion).[102] Distributions in excess of the accumulated pool of post-1986 undistributed E&P are treated as paid out of pre-1987 accumulated profits and are subject to the ordering principles of pre-1986 Act law.[103]

Foreign tax credit limitation

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).[104] This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous taxable year or carry forward the excess taxes to one of the succeeding 10 taxable years.[105]

The foreign tax credit limitation is generally applied separately to two different categories of income, passive category income and general category income.[106] Passive category income generally includes investment income such as dividends, interest, rents, and royalties.[107] General

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[100] Sec. 78.

[101] Sec. 902(c)(6)(B). E&P computations for these purposes are to be made under U.S. tax principles. Secs. 902(c)(1), 964(a).

[102] Sec. 902(c)(1).

[103] Sec. 902(c)(6).

[104] Secs. 901, 904.

[105] Sec. 904(c).

[106] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other sections. See, e.g., secs. 901(j), 904(h)(10), 865(h).

[107] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

category income is generally all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two categories, credits for foreign tax imposed on income in one category cannot be used to offset U.S. tax on income in the other category.

Income that would otherwise constitute passive category income is treated as general category income if it is earned by a qualifying financial services entity (and certain other requirements are met).[108] Passive income is also treated as general category income if it is high-taxed income (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as applicable).[109] Dividends (and subpart F inclusions), interest, rents, and royalties received from a CFC by a U.S. person are assigned to a separate limitation category by reference to the category of income out of which the dividend or other payment is made.[110] Dividends received by a U.S. person from a foreign corporation that is not a CFC are also categorized on a look-through basis.[111] For purposes of determining the foreign tax credit limitation, section 956 inclusions are treated as dividends.[112]

Under the foreign tax credit limitation rules, the total amount of the credit taken into account cannot exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's taxable income) bears to his entire taxable income for the same taxable year.

Explanation of Provision

The provision imposes a limit on the amount of foreign taxes that a U.S. Shareholder is deemed to pay under the foreign tax credit rules with respect to any section 956 inclusion.

For section 956 inclusions attributable to U.S. property acquired by a CFC after the effective date, the amount of foreign taxes deemed paid in each separate category is determined by comparing the foreign taxes deemed paid with respect to the U.S. Shareholder's section 956 inclusion (determined without regard to the provision) (the "tentative credit") to its hypothetical amount of foreign taxes deemed paid as computed under the provision (the "hypothetical credit"). The U.S. Shareholder's hypothetical credit is the amount of foreign taxes it would have been deemed to have paid if cash in an amount equal to the section 956 inclusion had been distributed through the chain of ownership that begins with the foreign corporation that holds the investment in U.S. property and ends with the U.S. Shareholder. If the hypothetical credit is less than the tentative credit, then the amount of foreign taxes deemed paid with respect to the section 956 inclusion is limited to the hypothetical credit. However, the amount of the tentative credit is

[108] Sec. 904(d)(2)(C), (D).

[109] Sec. 904(d)(2)(F).

[110] Sec. 904(d)(3).

[111] Sec. 904(d)(4).

[112] Sec. 904(d)(3)(G).

not increased if the hypothetical credit would have been greater than the tentative credit. This limitation applies whether the U.S. Shareholder chooses to claim a credit[113] for foreign taxes paid or accrued, or to deduct such taxes.[114]

In general, no special rules apply in determining the hypothetical credit. The only exception is that, to the extent an actual distribution would be subject to any income or withholding tax, such taxes are not taken into account in determining the hypothetical credit.[115] Thus, the generally applicable rules and definitions[116] apply to each hypothetical distribution. For example, assume that, for the relevant tax year, and before taking into account the hypothetical distribution under the provision, a U.S. parent ("USP") owns all of the vote and value of CFC1, a CFC organized in Country A with post-1986 undistributed earnings of 200u, and post-1986 foreign income taxes in the amount of $10.[117] CFC1 owns all of the vote and value of CFC2, a CFC organized in Country B with post-1986 undistributed earnings of 100u, and post-1986 foreign income taxes in the amount of $50. If CFC2 makes a loan to USP that results in a section 956 inclusion in the amount of 100u, the tentative credit is $50 (equal to 100u/100u x $50).

The hypothetical distribution of 100u from CFC2 to CFC1 would increase CFC1's current E&P by 100u, from 200u to300u, and increase CFC1's foreign income taxes from $10 to $60. The 100u hypothetical distribution results in a dividend of 100u that is non-subpart F income of CFC1 under the subpart F look-through rules.[118] Although Country B would impose a 10 percent withholding tax on an actual distribution of 100u to CFC1, for a total withholding tax of 10u, this amount is not taken into account in determining the hypothetical credit. Next, the 100u hypothetical distribution from CFC1 to USP would result in a dividend of 100u, on which

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113 Sec. 901.

114 Sec. 164(a)(3).

115 Similarly, if this hypothetical distribution would be subject to a withholding tax upon distribution to USP, if it had been actually made, any such tax would not be taken into account in determining the hypothetical credit. However, this conclusion results because such taxes are described in section 901(b), thus they are outside the scope of the provision.

116 See, e.g., secs. 902(b), (c), and 904(d)(3)(B), (D).

117 For purposes of this example, assume that each CFC has: (1) a "u" functional currency; (2) E&P comprising solely post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, such that there are no pre-1987 accumulated profits; (3) only post-1986 foreign income taxes; (4) no previously-taxed income; (5) only E&P and foreign income taxes in the section 904(d) general category; and (6) no other attributes than those listed. Except as provided in the example, there are no other distributions or inclusions during the taxable year. In addition, Country B imposes a 10-percent withholding tax on dividend payments to foreign shareholders.

118 Sec. 954(c)(6). This assumes that the subpart F look-through rules of section 954(c)(6) are extended, and are therefore applicable to the hypothetical distribution. In the event the look-through rule of section 954(c)(6) expires, the 100u hypothetical distribution would result in a dividend of 100u that would be currently included in USP's income as a subpart F item at the level of CFC1.

USP would be deemed to have paid $20 in taxes.[119] Because the hypothetical credit of $20 is less than the tentative credit of $50, USP's foreign taxes deemed paid with respect to its section 956 inclusion are limited to $20. USP's section 78 gross-up with respect to the section 956 inclusion is also $20.[120]

The provision is applied with regard to earnings and taxes in each separate category. In addition, treatment of any foreign taxes over the limit imposed under the provision (the "excess taxes") is the same as the treatment of any other foreign taxes paid or accrued, but not yet deemed paid for purposes of the foreign tax credit rules**.** Thus, if a foreign corporation's excess taxes are in its general category post-1986 foreign income taxes pool, the foreign corporation's excess taxes are still considered general category post-1986 foreign income taxes.[121] Accordingly, such taxes are included in the computation of foreign taxes deemed paid with respect to a subsequent distribution from, or income inclusion with respect to, that foreign corporation, subject to applicable limitations including the limitation of the provision. In the example above, excess taxes that remain at CFC2 equal $30.[122]

The provision applies to U.S. property acquired by a CFC after December 31, 2010. Thus, for example, any section 956 inclusions from a CFC loan that was made to its U.S. parent on or before December 31, 2010 would not be subject to the limitation imposed by the provision. However, the limitation imposed by the provision would apply if, after December 31, 2010, there is a significant modification of the debt instrument such that the original debt instrument is considered as exchanged for a modified instrument that differs materially from the original.[123]

The provision requires the Secretary to issue regulations to carry out its purposes, including regulations that prohibit inappropriate use of excess taxes. It is anticipated that such regulations would address transactions engaged in with a principal purpose to avoid the

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[119] The hypothetical amount of foreign taxes deemed paid equals (100u/300u) x $60. The post-1986 undistributed earnings that is the denominator of the section 902(a) fraction for purposes of the provision equals CFC1's post-1986 undistributed earnings of 200u (determined without regard to the provision) plus the amount of the hypothetical dividend from CFC2, 100u.

[120] If, in the same taxable year, CFC1 were also to make an actual distribution of all its accumulated E&P of 200u, the 100u hypothetical distribution from CFC1 to USP would have no impact on the calculation of USP's actual deemed paid credit from CFC1's actual dividend. The deemed-paid credit on the 200u dividend would be $10, which equals (200u/200u x $10). In addition, the calculation of the hypothetical credit with respect to the hypothetical distribution of 100u from CF2 would be the same (100u/300u x $60 = $20) whether or not CFC1 paid an actual dividend.

[121] Sec. 902(c)(2).

[122] The excess taxes equal the deemed paid foreign tax credit (determined without regard to the provision) of $50 minus the hypothetical credit of $20. Alternatively, if CFC2's E&P also included 125u in previously taxed income, then the excess taxes remaining at CFC2 would be $50, because the applicable ordering rules would prioritize the hypothetical distribution as coming first from the 125u in previously taxed income over the 100u in untaxed earnings. See sec. 959(c).

[123] See Treas. Reg. sec. 1.1001-3.

application of this provision, including through a series of transactions engaged in pursuant to a plan with such a principal purpose.

Effective Date

The provision is effective for acquisitions of United States property made by CFC's after December 31, 2010.

5. Special Rule with respect to certain redemptions by foreign subsidiaries (sec. 205 of the bill and sec. 304(b) of the Code)

Present Law

Under section 304, if one corporation (the "acquiring corporation") purchases stock of a related corporation (the "target corporation") in exchange for property, the transaction generally is recharacterized as a redemption. To the extent a section 304(a)(1) transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock of the target corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then transferred the property to the transferor in redemption of the stock it is deemed as having issued.[124] In the case of a section 304 transaction, the amount and the source of a dividend are determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits ("E&P"), and then by the target corporation to the extent of its E&P.[125] To the extent the dividend is sourced from the E&P of the acquiring corporation, the transferor is considered to receive the dividend directly from the acquiring corporation;[126] this is commonly referred to as "hopscotching" because the dividend bypasses any intermediary shareholders.

Special rules apply if the acquiring corporation is foreign.[127] For purposes of determining the amount of the dividend to the transferor, the foreign acquiring corporation's E&P that is taken into account is limited to the portion of such E&P that (1) is attributable to stock of the foreign acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) of the target corporation and who is a U.S. shareholder[128] of the foreign acquiring corporation and (2) was accumulated while such stock was owned by the transferor (or

[124] Sec. 304(a)(1).

[125] Sec. 304(b)(2).

[126] See H.R. Rep. No. 98-861 (1984) (Conf. Rep.), 1222-1224; Rev. Rul. 80-189, 1980-2 C.B. 106.

[127] Sec. 304(b)(5).

[128] As that term is defined by section 951(b).

a person related thereto) and while the foreign acquiring corporation was a controlled foreign corporation ("CFC").[129]

Section 1442 generally requires a 30-percent gross basis tax to be withheld on dividend payments to foreign persons unless reduced or eliminated pursuant to an applicable income tax treaty.

Explanation of Provision

The provision generally imposes an additional limitation on the E&P of a foreign acquiring corporation that is taken into account in determining the amount (and source) of the distribution that is treated as a dividend.

Under the provision, if more than 50 percent of the dividends arising from acquisition (before taking into account the provision) would not be (1) subject to U.S. tax in the year in which the dividend arises or (2) includible in the E&P of a CFC,[130] then the E&P of the foreign acquiring corporation is not taken into account.[131]

If it is determined that the special rule applies, none of the foreign acquiring corporation's E&P is taken into account. In such case, the only E&P that is taken into account to determine the amount constituting a dividend is the target corporation's E&P. Where applicable, the special rule effectively prevents the foreign acquiring corporation's E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation. Generally, if the transferor is a foreign corporation (and not a CFC) and the acquiring corporation is a CFC, it is not relevant whether the target corporation is a domestic or a foreign corporation. However, if the target is a U.S. corporation, the 30-percent gross basis withholding tax applies to the amount constituting a dividend from the target, unless reduced or eliminated by treaty.[132]

It is anticipated that regulations will provide a rule to prevent the avoidance of the provision, including through the use of partnerships, options, or other arrangements to cause a foreign corporation to be treated as a CFC.

Effective Date

The provision is effective for acquisitions after December 31, 2010.

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[129] See sec. 304(b)(5).

[130] For purposes of this rule, "CFC" is defined by reference to section 957, but without regard to section 953(c).

[131] It is not intended that the provision apply if an amount is not subject to tax under this chapter for the taxable year in which the dividend arises solely as a result of the application of section 959.

[132] Sec. 1442; Rev. Rul. 92-85; 1992-2 C.B. 69.

6. Modification of affiliation rules for purposes of rules allocating interest expense (sec. 206 of the bill and sec. 864 of the Code)

Present Law

In general

The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. 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 foreign-source income without offsetting the U.S. tax on U.S.-source income.[133]

To compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources by allocating and apportioning deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other. There are no specific rules for most types of deductions.[134] Specific provisions govern the allocation and apportionment of interest.[135]

For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income.[136]

Foreign corporations owned by an affiliated group of corporations

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.[137] These rules exclude all foreign corporations from an affiliated group.[138] Thus, while debt generally is

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[133] Secs. 901, 904.

134 See, e.g., secs. 861(b), 862(b), and 863(a), which require that a taxpayer properly allocate and apportion expenses, losses, or other deductions, without containing any specific rules for allocating and apportioning particular types of deductions.

[135] Sec. 864(e). In the case of interest expense, the rules generally are based on the premise 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. Temp. Reg. sec. 1.861-9T(a).

[136] Secs. 864(e)(1), 864(e)(2).

[137] Secs. 864(e)(5)(A), sec. 1504. The affiliated group for interest allocation purposes generally excludes certain corporations that are financial institutions. These corporate financial institutions are not treated as members of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such corporate financial institutions that would be so affiliated are treated as a separate single corporation for interest allocation purposes. Sec. 864(e)(5)(B).

[138] Sec. 1504(b)(3).

considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Under Treasury regulations, however, certain foreign corporations are treated as affiliated corporations, in certain respects, if (1) at least 80 percent of either the vote or value of the corporation's outstanding stock is owned directly or indirectly by members of an affiliated group, and (2) more than 50 percent of the corporation's gross income for the taxable year is effectively connected with the conduct of a U.S. trade or business (also known as effectively connected income).[139]

In the case of a foreign corporation that is treated as an affiliated corporation for interest allocation and apportionment purposes, the percentage of its assets and income that is taken into account varies depending on the percentage of the corporation's gross income that is effectively connected income. If 80 percent or more of the foreign corporation's gross income is effectively connected income, then all the corporation's assets and interest expense are taken into account. If, instead, between 50 percent and 80 percent of the foreign corporation's gross income is effectively connected income, then only the corporation's assets that generate effectively connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively connected income are taken into account.[140]

Explanation of Provision

The provision treats a foreign corporation as a member of an affiliated group, for interest allocation and apportionment purposes, if (1) more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected income, and (2) at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). Thus, under the provision, if more than 50 percent of a foreign corporation’s gross income is effectively connected income and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group, then all of the foreign corporation’s assets and interest expense are taken into account for the purposes of allocating and apportioning the interest expense of the affiliated group.

[139] Temp. Reg. sec. 1.861-11T(d)(6)(ii). The question as to whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person. Generally, only U.S.-source income is treated as effectively connected with the conduct of a U.S. trade or business. However, certain limited categories of foreign-source income are treated as effectively connected if the income is attributable to an office or other fixed place of business maintained by the foreign person in the United States. Sec. 864(c).

[140] Temp. Reg. sec. 1.861-11T(d)(6)(ii).

Effective Date

The provision applies to taxable years beginning after the date of enactment.

7. Termination of special rules for interest and dividends received from persons meeting the 80-percent foreign business requirements (sec. 207 of the bill and secs. 861(a)(1)(A) and 871(i) of the Code)

Present Law

The source of interest and dividend income generally is determined by reference to the country of residence of the payor.[141] Thus, an interest or dividend payment from a U.S. payor to a foreign person generally is treated as U.S.-source income and is subject to the 30-percent gross-basis U.S. withholding tax.[142] However, if a resident alien individual or domestic corporation satisfies an 80-percent active foreign business income requirement (the "80/20 test"), all or a portion of any interest paid by the resident alien individual or the domestic corporation (a so-called "80/20 company") is exempt from U.S. withholding tax. Interest paid by a resident alien individual that satisfies the 80/20 test or by an 80/20 company is treated as foreign-source income and is therefore exempt from the 30-percent withholding tax if it is paid to unrelated parties.[143] When a resident alien individual or 80/20 company pays interest to a related party, the resourcing rule applies only to the percentage of the interest that is equal to the percentage of the resident alien individual's or 80/20 company's foreign-source income (described below) as a portion of the resident alien individual's or 80/20 company's total gross income during the three-year testing period (a so-called "look-through" approach).[144]

In addition to interest, all or part of a dividend paid by an 80/20 company may also be exempt from U.S. withholding tax. The percentage of the dividend paid by an 80/20 company that equals the percentage of the 80/20 company's total gross income during the testing period that is foreign source is exempt from U.S. withholding tax.[145] Unlike interest, a dividend paid by an 80/20 company remains U.S. source (for example, for foreign tax credit limitation purposes).

In general, a resident alien individual or domestic corporation meets the 80/20 test if at least 80 percent of the gross income of the resident alien individual or corporation during the testing period is derived from foreign sources and is attributable to the active conduct of a trade or business in a foreign country (or a U.S. possession) by the resident alien individual or corporation or, in the case of a corporation, a 50-percent owned subsidiary of that corporation.

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[141] Secs. 861(a)(1), (2), 862(a)(1), (2).

[142] Secs. 871(a)(1)(A), 881(a)(1), 1441(b), 1442(a).

[143] Sec. 861(a)(1)(A).

[144] Sec. 861(c)(2).

[145] Sec. 871(i).

The testing period generally is the three-year period preceding the year in which the interest or dividend is paid.[146]

Explanation of Provision

The provision repeals the present law rule that treats as foreign source all or a portion of any interest paid by a resident alien individual or domestic corporation that meets the 80/20 test. The provision also repeals the present law rule that exempts from U.S. withholding tax all or a portion of any dividends paid by a domestic corporation that meets the 80/20 test.

The provision provides a grandfather rule for any domestic corporation that (1) meets the 80/20 test (as in effect before the enactment of this provision) (hereinafter "the present law 80/20 test") for its last taxable year beginning before January 1, 2011 ("an existing 80/20 company"), (2) meets a "new 80/20 test" with respect to each taxable year beginning after December 31, 2010, and (3) has not added a substantial line of business with respect to such corporation after the date of enactment of this provision. Any payment of dividend or interest after December 31, 2010 by an existing 80/20 company that meets the grandfather rule will be exempt from withholding tax to the extent of the existing 80/20 company's active foreign business percentage. Nonetheless, any payment of interest will be treated as U.S.-source income.

As with the present law 80/20 test, a corporation meets the 80-percent foreign business requirements of the new 80/20 test if it is shown to the satisfaction of the Secretary that at least 80-percent of the gross income from all sources of such corporation for the testing period is active foreign business income. This percentage—active foreign business income of the company for the testing period as a percentage of total gross income of the company for the testing period—is also the company's active foreign business percentage for purposes of determining the portion of any dividend or interest paid by an existing 80/20 company that is exempt from withholding tax. However, except as modified by the transition rule below, the existing 80/20 company and all of its subsidiaries are aggregated and treated as one corporation. For this purpose, a subsidiary means any corporation in which the existing 80/20 company owns (directly or indirectly) stock meeting the requirements of section 1504(a)(2), determined by substituting 50 percent for 80 percent and without regard to section 1504(b)(3). As a result, an existing 80/20 company must take into account the gross income of any domestic or foreign subsidiary. The Secretary may issue guidance as is necessary or appropriate to carry out the purpose of this provision, including guidance providing for the proper application of the aggregation rules.

Under the new 80/20 test, the testing period is the three-year period ending with the close of the taxable year of the corporation preceding the payment (or such part of such period as may be applicable). If the corporation has no gross income for such three-year period (or part thereof), the testing period is the taxable year in which the payment is made.

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[146] Sec. 861(c)(1). The income of a subsidiary is attributed to the tested company only to the extent that the tested company actually receives income from the subsidiary in the form of dividends. *Conference Report to the 1986 Tax Reform Act,* Pub. L. No. 99-514, Vol II, 602; see also Rev. Rul. 73-63, 1973-1 C.B. 336; P.L.R. 6905161160A (May 16, 1969).

The grandfather rule includes a transition rule that applies in the case of any taxable year for which the testing period includes one or more taxable years beginning before January 1, 2011. Under this transition rule, a corporation meets the 80-percent foreign business requirements if, and only if, the weighted average of (1) the percentage of the corporation's gross income from all sources that is active foreign business income (as defined in subparagraph (B) of section 861(c)(1) (as in effect before the date of enactment of this provision)) for the portion of the testing period that includes taxable years beginning before January 1, 2011,[147] and (2) the percentage of the corporation's gross income from all sources that is active foreign business income for the portion of the testing period, if any, that includes taxable years beginning on or after January 1, 2011, is at least 80 percent. Accordingly, this transition rule applies instead of the new 80/20 test for the relevant tax years. This weighted average percentage is also treated as the active foreign business percentage for purposes of determining the amount of withholding for such taxable years.

The following example illustrates the operation of this transition rule. Assume a domestic corporation has $100 of active foreign business income and no other income on a separate company basis (i.e., without regard to the income of any affiliate) for each of the 2008, 2009, and 2010 tax years. For the 2011, 2012, and 2013 tax years, the domestic company has $700 of active foreign business income and $300 of other income on an aggregate basis (including the income of its 50-percent owned domestic and foreign subsidiaries). Under the provision, the domestic company's weighted average percentage for the 2011 tax year is 100 percent, determined by considering the 2008, 2009, and 2010 tax years on a separate company basis (($100 + $100 + $100)/($100 + $100 + $100)). Therefore, for the 2011 tax year, the domestic company meets the 80-percent active foreign business requirements, and its active foreign business percentage is 100 percent for the 2011 tax year.

For the 2012 tax year, the weighted average percentage is 90 percent, determined by considering the 2009 and 2010 tax years on a separate company basis ((($100 + $100)/($100 + $100) x 2/3)) or 66.7 percent) and the 2011 tax year on an aggregate basis ((($700/$1,000) x 1/3) or 23.3 percent). As a result, the domestic company meets the 80-percent active foreign business requirements, and its active foreign business percentage is 90 percent for the 2012 tax year.

For the 2013 tax year, the weighted average percentage is 80 percent, determined by considering the 2010 tax year on a separate company basis ((($100/$100) x 1/3) or 33.3-percent) and the 2011 and 2012 tax years on an aggregate basis ((($700 + $700)/($1,000 + $1,000) x 2/3) or 46.7 percent). Therefore, for the 2013 tax year, the domestic company meets the 80-percent active foreign business requirements, and its active foreign business percentage is 80 percent.

For the 2014 tax year, the transition rule does not apply since none of the years within the three-year testing period begin before January 1, 2011. As a result, the domestic company does not meet the 80-percent foreign business requirements for the 2014 tax year since only 70 percent (($700 + $700 + $700)/($1,000 + $1,000 + $1,000)) of its gross income from all sources for the testing period is active foreign business income.

[147] Hence, this percentage is determined without application of the new aggregation rule.

An existing 80/20 company does not meet the grandfather rule if there has been an addition of a substantial line of business with respect to such corporation after the date of enactment of this provision. For purposes of determining whether a substantial line of business has been added, rules similar to those of section 7704(g) and the Treasury regulations thereunder (relating to certain publicly-traded partnerships treated as corporations) apply. It is anticipated that the Secretary will issue guidance providing that the acquisition of foreign operating assets or stock of a foreign corporation by the existing 80/20 company for the purpose of increasing its active foreign business percentage will be treated as the addition of a substantial line of business.

The repeal of the 80/20 company provisions relating to the payment of interest does not apply to payments of interest to persons not related to the 80/20 company (applying rules similar to those of section 954(d)(3)) on obligations issued before the date of enactment.[148] For this purpose, a significant modification of the terms of any obligation (including any extension of the term of such obligation) is treated as the issuance of a new obligation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

8. Source rules for income on guarantees (sec. 208 of the bill and secs. 861, 862 and 864 of the Code)

Present Law

The United States taxes U.S. citizens and residents (including domestic corporations) on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations engaged in a trade or business in the United States on income that is effectively connected with the conduct of such trade or business (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with the conduct of a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are connected with effectively connected income.[149] A foreign

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[148] A person will be treated as a related person with respect to a controlled foreign corporation if (A) such person is an individual, corporation, partnership, trust or estate which controls, or is controlled by, the controlled foreign corporation, or (B) such person is a corporation, partnership, trust or estate which is controlled by the same person or persons which control the resident controlled foreign corporation. For purposes of the preceding sentence, control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of stock of such corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interests in such partnership, trust, or estate. For purposes of this paragraph, rules similar to the rules of section 958 shall apply. Sec. 954(d)(3).

[149] Secs. 864(c), 871(b), 873, 882(a) and 882(c).

corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business.[150] In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.[151]

Subject to a number of exceptions, U.S.-source fixed or determinable, annual or periodical income ("FDAP") of a nonresident alien individual or foreign corporation that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid.[152] Items of income within the scope of FDAP include, for example, interest, dividends, rents, royalties, salaries, and annuities. The tax generally is collected by means of withholding.[153]

Present law provides detailed rules for the determination of whether income is from U.S. sources or foreign sources. For example, the source of compensation for services is generally determined by the location in which the services were performed, regardless of the country of residence of the payor.[154] In contrast, the source of interest income is generally determined by reference to the country of residence of the obligor.[155] As a result, interest paid by a U.S. obligor typically is considered U.S.-source income, while interest paid by a foreign obligor is treated as foreign-source income. Rents and royalties paid for the use of property located in the United States are considered to be U.S.-source income.[156]

To the extent that the source of income is not specified in the statute, the Secretary may promulgate regulations that allocate or apportion such income to sources within or without the United States.[157] Many items of income are not explicitly addressed by either the statute or the regulations. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[158] As a result, items as dissimilar as alimony and letters of credit

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[150] Sec. 884.

[151] Sec. 884(f).

[152] Secs. 871(a), 881(a).

[153] Sec. 1441 and 1442 provide for withholding from payments to nonresident aliens and foreign corporations, respectively.

[154] Under section 861(a)(3), compensation for personal services performed in the United States is generally U.S. source. Conversely, section 862(a)(3) provides that compensation for labor or services performed outside the United States is foreign source.

[155] Secs. 861(a)(1), 862(a)(1).

[156] Sec. 861(a)(4).

[157] Sec. 863.

[158] *See*, *Hunt v. Commissioner*, 90 T.C. 1289 (1988).

commissions were sourced by analogy to interest.[159] The U.S. Tax Court, in *Container Corp. v. Commissioner*, [160] recently rejected IRS arguments that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the U.S. subsidiary were analogous to interest for purposes of determining the source of such payments. The Tax Court held that the payments were more closely analogous to compensation for services, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

Explanation of Provision

This provision effects a legislative override of the opinion in *Container Corp. v. Commissioner, supra,* by amending the source rules of section 861 and 862 to address income from guarantees issued after the date of enactment. Under section 861(a)(9), income from sources within the United States includes amounts received, whether directly or indirectly, from a noncorporate resident or a domestic corporation for the provision of a guarantee of indebtedness of such person. The scope of the provision includes payments that are made indirectly for the provision of a guarantee. For example, the provision would treat as income from U.S. sources a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for example, additional interest charged on the indebtedness.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income which is effectively connected with conduct of a U.S. trade or business. A conforming amendment to section 862 provides that amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign source income if they are not from sources within the United States as determined under section 861(a)(9).

For purposes of this provision, the phrase "noncorporate residents" has the same meaning as for purposes of section 861(a)(1), except that foreign partnerships are not included. Payments received from a foreign partnership for the provision of a guarantee of indebtedness of that foreign partnership are U.S. source if the amounts received are connected with income which is effectively connected with the conduct of a U.S. trade or business. A conforming amendment to section 864 provides that amounts received, whether directly or indirectly, for the provision of a guarantee are deemed to be effectively connected with the conduct of a U.S. trade or business if derived in the active conduct of a banking, financing or similar business.

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[159] *Manning v. Commissioner*, T.C. Memo. 1979-146, *aff'd* 614 F.2d 815 (1st Cir. 1980); *Bank of America v. United States*, 230 Ct. Cl. 679, 680 F.2d 142 (1982), *aff'g* in part, *rev'g* in part, 47 AFTR 2d 81-652 (Ct. Cl. 1981).

[160] *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), *gov't notice of appeal filed* (5th Cir. June 1, 2010).

Although this provision overturns the opinion in *Container Corp. v. Commissioner, supra,* no inference is intended with respect to the source of income received for the provision of a guarantee issued before the date of enactment. The Secretary may provide rules for determining the source of other types of payments that are not within the scope of this provision.

Effective Date

The provision applies to guarantees issued after the date of enactment. No inference is intended with respect to the source of income received for the provision of a guarantee issued before the date of enactment.

9. Modification of statute of limitations for failure to disclose certain foreign transactions (sec. 209 of the bill and sec. 6501(c) of the Code)

Present Law

Taxes are generally required to be assessed within three years after a taxpayer's return was filed, whether or not it was timely filed.[161] In the case of a false or fraudulent return filed with the intent to evade tax, or if the taxpayer fails to file a required return, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.[162] The limitation period also may be extended by taxpayer consent.[163] If a taxpayer engages in a listed transaction but fails to include any of the information required under section 6011 on any return or statement for a taxable year, the limitation period with respect to such transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is provided the information so required, or (2) the date that a "material advisor" (as defined in section 6111) makes its section 6112(a) list available for inspection pursuant to a request by the Secretary under section 6112(b)(1)(A).[164] In addition to the exceptions described above, there are also circumstances under which the three-year limitation period is suspended.[165]

Section 6501(c)(8) provides an exception to the three-year period of limitations due to failures to provide information about cross-border transactions or foreign assets. Under this exception, as amended by "Hiring Incentives to Restore Employment Act,"[166] the limitation

[161] Sec. 6501(a). Returns that are filed before the date they are due are deemed filed on the due date. See sec. 6501(b)(1) and (2).

[162] Sec. 6501(c).

[163] Sec. 6501(c)(4).

[164] Sec. 6501(c)(10).

[165] For example, service of an administrative summons triggers the suspension either (1) beginning six months after service (in the case of John Doe summonses) or (2) when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record-keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

[166] Sec. 513, Pub. L. 111-147.

period for assessment of tax does not expire any earlier than three years after the required information about certain cross-border transactions or foreign assets is actually provided to the Secretary by the person required to file the return.[167] In general, such information reporting is due with the taxpayer's return; thus, the three-year limitation period commences when a timely and complete return (including all information reporting) is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are subsequently provided to the Secretary, even though the return has been filed. The taxes that may be assessed during this suspended or extended period are not limited to those attributable to adjustments to items related to the information required to be reported by one of the enumerated sections.

Explanation of Provision

The provision modifies the scope of the exception to the limitations period if a failure to provide information on cross-border transactions or foreign assets is shown to be due to reasonable cause and not willful neglect. In the absence of reasonable cause or the presence of willful neglect, the suspension of the limitations period and the subsequent three-year period that begins after information is ultimately supplied apply to all issues with respect to the income tax return. In cases in which a taxpayer establishes reasonable cause, the limitations period is suspended only for the item or items related to the failure to disclose. In order to prove reasonable cause, it is anticipated that a taxpayer must establish that the failure was objectively reasonable (i.e., the existence of adequate measures to ensure compliance with rules and regulations), and in good faith.

For example, the limitations period for assessing taxes with respect to a tax return filed on March 31, 2011 ordinarily expires on March 31, 2014. In order to assess tax with respect to any issue on the return after March 31, 2014, the IRS must be able to establish that one of the exceptions applies. If the taxpayer fails to attach to that return one of multiple information returns required, the limitations period does not begin to run unless and until that missing information return is supplied. Assuming that the missing report is supplied to the IRS on January 1, 2013, the limitations period for the entire return begins, and elapses no earlier than three years later, on January 1, 2016. All items are subject to adjustment during that time, unless the taxpayer can prove that reasonable cause for the failure to file existed. If the taxpayer establishes reasonable cause, the only adjustments to tax permitted after March 31, 2014 are those related to the failure to file the information return. For this purpose, related items include (1) adjustments made to the tax consequences claimed on the return with respect to the transaction that was the subject of the information return, (2) adjustments to any item to the extent the item is affected by the transaction even if it is otherwise unrelated to the transaction,

[167] Required information reporting subject to this three-year rule is reporting under sections 6038 (certain foreign corporations and partnerships), 6038A (certain foreign-owned corporations), 6038B (certain transfers to foreign persons), 6038D (individuals with foreign financial assets), 6046 (organizations, reorganizations, and acquisitions of stock of foreign corporations), 6046A (interests in foreign partnerships), and 6048 (certain foreign trusts), as well as information required with respect to elections under sections 1295(b) passive foreign investment corporations.

and (3) interest and penalties that are related to the transaction or the adjustments made to the tax consequences.

Effective Date

The provision applies to returns filed after March 18, 2010, the date of enactment of "Hiring Incentives to Restore Employment Act," Public Law 111-147, as well as for any other return for which the assessment period specified in section 6501 had not yet expired as of that date.

B. Other Revenue Provisions

1. Require minimum 10-year term and other modifications for qualification of grantor retained annuity trusts (GRATs) (sec. 211 of the bill and sec. 2702(b) of the Code)

Present Law

Overview

Present law provides special rules for valuing certain transfers in trust of temporal interests in property (such as annuity interests and remainder interests).[168] Present law also provides rules for determining when a grantor of a trust will be treated as the owner of all or part of the trust for income tax purposes.[169] Grantor retained annuity trusts (GRATs) are vehicles, often structured as grantor-owned, that are used to make transfers of temporal interests in property.

Valuation of certain transfers in trust

In the event of a lifetime transfer in trust to (or for the benefit of) a member of the transferor's family where the transferor or an applicable family member retains any interest in the trust, a special rule applies for purposes of determining the value of the transferor's gift.[170] In general, the value of any retained interest that is not a "qualified interest" is treated as zero.[171] Therefore, where a transferor retains an interest that is not a qualified interest, the entire amount transferred to the trust generally is treated as a gift by the transferor to the remainder beneficiaries, which gift is subject to transfer taxation.[172] The value of a retained interest that is a qualified interest, on the other hand, is determined using rates and procedures described in the Code for valuing temporal interests in property.[173]

For these purposes, the term "qualified interest" means: (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually (i.e., a qualified annuity interest); (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually) (i.e., a qualified unitrust interest); and (3) any

[168] See sec. 2702.

[169] See secs. 671-679.

[170] Sec. 2702(a)(1).

[171] Sec. 2702(a)(2)(A).

[172] The special valuation rule does not apply in certain excepted situations, including: (1) where the transfer is not a completed gift; and (2) transfers to certain personal residence trusts. See sec. 2702(a)(3).

[173] Sec. 2702(a)(2)(B); sec. 7520.

noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2) (i.e., a qualified remainder interest).[174]

A qualified interest is valued under procedures described in section 7520 using tables prescribed by the Secretary of the Treasury and an interest rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the Federal midterm interest rate in effect under section 1274(d)(1) for the month in which the valuation date falls. The tables and rates described in section 7520 assume that the assets in a trust will grow at a relatively modest rate.

<u>"Grantor trust" rules</u>

For income tax purposes, a trust generally is a separate taxpayer. Under certain circumstances, however, a grantor is treated as the owner of all or part of a trust for income tax purposes.[175] When a grantor is treated as owner of a trust, the grantor, when computing his or her taxable income and credits, generally must include items of income, deductions, and credits of the trust attributable to the portion of the trust deemed owned by the grantor for income tax purposes.[176]

The Code includes a number of rules regarding when a grantor or another person is treated as the owner of all or part of a trust for income tax purposes.[177] A grantor may, for example, be treated as the owner of a trust for income tax purposes where the grantor has: (1) a sufficient reversionary interest in the corpus or income of the trust;[178] (2) the power to control beneficial enjoyment of the corpus or income of the trust;[179] (3) certain administrative powers;[180] (4) the power to revoke all or part of the trust;[181] or (5) the power to distribute income to or for the benefit of the grantor.[182]

A trust that is structured such that the grantor is treated as the owner for income tax purposes, but not for gift or estate tax purposes, is sometimes referred to as an "intentionally defective grantor trust."

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[174] Sec. 2702(b).

[175] See secs. 671-679.

[176] See sec. 671.

[177] See secs. 673-677.

[178] Sec. 673.

[179] Sec. 674.

[180] Sec. 675.

[181] Sec. 676.

[182] Sec. 677.

Grantor retained annuity trusts

A GRAT generally is an irrevocable trust in which the grantor retains an annuity interest structured as a "qualified interest" under section 2702. The annuity interest must be an irrevocable right to receive a fixed amount at least annually.[183] The trustee must be required to invade the principal of the trust in the event the income is insufficient to pay the qualified annuity.

Assuming the transfer of assets to the trust is treated as a completed gift for gift tax purposes, the gift to the remainder beneficiaries generally will be subject to gift tax as of the time of the initial transfer of assets to the trust. Therefore, the grantor will be required to use a portion of his or her gift tax exemption equal to − or, to the extent insufficient exemption remains, to pay gift tax on − the value of the remainder interest determined as of the time the grantor funds the trust. The annuity portion of a GRAT is valued using the procedures for valuing qualified interests outlined in section 7520 (described above). To value the remainder interest in a GRAT, the value of any qualified interest, as determined under section 7520, is subtracted from the value of the property transferred to the trust.

When the grantor's retained annuity interest expires, the trust assets are distributed to one or more remainder beneficiaries identified in the trust instrument. Because the value of the transferor's gift for gift tax purposes is determined at the time of the transfer, if trust property grows at a rate in excess of the growth rate assumed under section 7520, the excess appreciation generally will pass to the remainder beneficiaries without further gift tax consequences to the grantor. If, however, the grantor dies during the trust term, that portion of the trust necessary to generate the annuity amount will be included in the grantor's gross estate for estate tax purposes.[184] Such inclusion generally results in the loss of the transfer tax benefit of using a GRAT.

A GRAT is a grantor trust; therefore, the grantor is treated as owner of the trust during the term of the annuity interest, and the grantor generally must include in determining his or her taxable income and credits the income, deductions, and credits of the trust.

Explanation of Provision

The provision adds certain requirements for an annuity interest retained by the transferor to be treated as a qualified interest for purposes of the special valuations rules applicable to transfers of a trust interest to a member of the transferor's family: (1) the retained annuity interest must have a term not less than 10 years; (2) the annuity (determined on an annual basis) may not decline during the first 10 years of the annuity term; and (3) the remainder interest must have a value greater than zero at the time of the transfer.

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[183] Treas. Reg. sec. 25.2702-3(b).

[184] Sec. 2036.

Effective Date

The provision applies to transfers made after the date of enactment.

2. Crude tall oil ineligible for the cellulosic biofuel producer credit (sec. 212 of the bill and sec. 40 of the Code)

Present Law

The "cellulosic biofuel producer credit" is a nonrefundable income tax credit for each gallon of qualified cellulosic biofuel production of the producer for the taxable year. The amount of the credit is generally $1.01 per gallon.[185]

"Qualified cellulosic biofuel production" is any cellulosic biofuel which is produced by the taxpayer and which is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified cellulosic biofuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or (c) who sells such cellulosic biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).

"Cellulosic biofuel" means any liquid fuel that (1) is produced in the United States and used as fuel in the United States, (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act. The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of cellulosic biofuel.

Cellulosic biofuel does not include certain unprocessed fuel. Unprocessed fuels are fuels which (1) are more than four percent (determined by weight) water and sediment in any combination, or (2) have an ash content of more than one percent (determined by weight).[186] Cellulosic biofuel eligible for the section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.[187]

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[185] In the case of cellulosic biofuel that is alcohol, the $1.01 credit amount is reduced by the credit amount of the alcohol mixture credit, and for ethanol, the credit amount for small ethanol producers, as in effect at the time the cellulosic biofuel fuel is produced.

[186] Water content (including both free water and water in solution with dissolved solids) is determined by distillation, using for example ASTM method D95 or a similar method suitable to the specific fuel being tested. Sediment consists of solid particles that are dispersed in the liquid fuel and is determined by centrifuge or extraction using, for example, ASTM method D1796 or D473 or similar method that reports sediment content in weight percent. Ash is the residue remaining after combustion of the sample using a specified method, such as ASTM D3174 or a similar method suitable for the fuel being tested.

[187] See secs. 40A(d)(1), 40A(f)(3), and 6426(h).

Because it is a credit under section 40(a), the cellulosic biofuel producer credit is part of the general business credits in section 38. However, unlike other general business credits, the cellulosic biofuel producer credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under section 87, the credit is included in gross income. The cellulosic biofuel producer credit terminates on December 31, 2012.

The kraft process for making paper produces a byproduct called black liquor, which has been used for decades by paper manufacturers as a fuel in the papermaking process. Black liquor is composed of water, lignin and the spent chemicals used to break down the wood. The amount of the biomass in black liquor varies. The portion of the black liquor that is not consumed as a fuel source for the paper mills is recycled back into the papermaking process. Black liquor has ash content (mineral and other inorganic matter) significantly above that of other fuels.

Crude tall oil is generated by reacting acid with black liquor soap. Crude tall oil is used in various applications, such as adhesives, resins and inks. It also can be burned and used as a fuel.

Explanation of Provision

The provision modifies the cellulosic biofuel producer credit to exclude from the definition of cellulosic biofuel fuels with an acid number of greater than 25. The acid number is the amount of base required to neutralize the acid in the sample. The acid number is reported as weight of the base (typically potassium hydroxide) per weight of sample, or milligram ("mg") potassium hydroxide per gram. The normal acid number for crude tall oil is between 100 and 175. As a comparison, ASTM D6751 for biodiesel specifies that the acid number be less than 0.5mg potassium hydroxide. ASTM D4806 for ethanol does not have acid value but instead limits "acidity" to 0.007 mg of acetic acid per liter, which is significantly below an acid number of 25.

Effective Date

The provision is effective for fuels sold or used on or after January 1, 2010.

3. Increase in information return penalties (sec. 213 of the bill and secs. 6721 and 6722 of the Code)

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721, any person who is required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the “second-tier penalty”), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return (the “third-tier penalty”), with a maximum penalty of $250,000 per calendar year. If a failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is $100, with no calendar year limit.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

Explanation of Provision

The provision increases the first-tier penalty from $15 to $30, and increases the calendar year maximum from $75,000 to $250,000. The second-tier penalty is increased from $30 to $60, and the calendar year maximum is increased from $150,000 to $500,000. The third-tier penalty is increased from $50 to $100, and the calendar year maximum is increased from $250,000 to $1,500,000. For small business filers, the calendar year maximum is increased from $25,000 to $75,000 for the first-tier penalty, from $50,000 to $200,000 for the second-tier penalty, and from $100,000 to $500,000 for the third-tier penalty. The minimum penalty for each failure due to intentional disregard is increased from $100 to $250. The provision also provides that the penalty amounts will be adjusted to account for inflation.

Effective Date

The provision applies with respect to information returns required to be filed on or after January 1, 2011.

4. Treatment of securities of a controlled corporation exchanged for assets in certain reorganizations (sec. 214 of the bill and sec. 361 of the Code).

Present Law

The transfer of assets by a transferor corporation to another corporation, controlled (immediately after the transfer) by the transferor or one or more of its shareholders, will qualify as a tax-free reorganization if the transfer is made by one corporation ("distributing") of a part of its assets consisting of an active trade or business meeting certain requirements to a controlled subsidiary corporation ("controlled"), followed by the distribution of the stock and securities of the controlled subsidiary in a divisive spin-off, split-off, or split-up which was not used principally as a device for the distribution of earnings and profits ("divisive D reorganization").[188]

No gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.[189] If property other than stock or securities is received ("other property"), gain is recognized to the extent the other property is not distributed.[190]

In addition, in the case of a transfer of money or other property received in the exchange to the corporation's creditors in connection with the reorganization, gain is recognized to the extent the sum of the money and the fair market value of the other property exceeds the adjusted bases of the assets transferred (net of liabilities).[191] Such a transfer to creditors is aggregated with other assumptions of the transferor corporation's liabilities by the transferee, which generally cause gain recognition if they exceed the adjusted basis of assets transferred.[192]

For example, if in a divisive D reorganization the controlled corporation either (1) directly assumes the debt of the distributing corporation, or (2) borrows and distributes cash to the distributing corporation to pay the distributing corporation's creditors, such debt assumption or cash distribution is treated as money received by the distributing corporation, and is taxable to the extent it exceeds the distributing corporation's basis in the assets transferred to the controlled corporation. By contrast, if the controlled corporation leverages itself by issuing its debt securities to the distributing corporation, the controlled corporation's debt securities are not treated as money received by the distributing corporation. Thus, the distributing corporation could use the controlled corporation's securities to retire the distributing corporation's own debt, recognize no gain, and be in the same economic position as if its debt had been directly assumed by the controlled corporation or as if it had retired its debt with cash received from the controlled corporation.

Explanation of Provision

Under the provision, in the case of a divisive D reorganization, no gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock other than nonqualified

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[188] Secs. 355 and 368(a)(1)(D). Section 355 imposes other requirements to avoid gain recognition at the corporate level with respect to the spin off, split up, or split off, e.g., secs. 355(d) and (e).

[189] Sec. 361(a).

[190] Sec. 361(b).

[191] The last sentence of sec. 361(b)(3).

[192] Sec. 357(c).

preferred stock (as defined in section 351(g)(2)).[193] Thus, under the provision, securities and nonqualified preferred stock are treated as "other property."

Under the provision, the transferor corporation's gain on the exchange is recognized to the extent of the sum of money and the value of other property, including securities and nonqualified preferred stock, not distributed in pursuance of the plan of reorganization. Also, gain on the exchange is recognized to the extent that the sum of money and the value of all property other than stock that is not nonqualified preferred stock which is transferred to creditors exceeds the adjusted bases of the assets transferred (net of liabilities).

For example, under the provision, in a divisive D reorganization, the exchange of the controlled corporation's securities for the distributing corporation's securities would be treated in the same manner as (1) the assumption of the distributing corporation's debt by the controlled corporation or (2) the use of a cash distribution from the controlled corporation to retire debt of the distributing corporation.

Effective Date

The provision applies to exchanges occurring after the date of enactment.

However, the provision does not apply to any exchange in connection with a transaction which is (i) made pursuant to an agreement which was binding on March 15, 2010, and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

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[193] Section 351(g)(2) defines nonqualified preferred stock as preferred stock if (i) the holder has a right to require the issuer or a related person to redeem or purchase the stock, which right may be exercised within the 20 year period beginning on the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of redemption or purchase; (ii) the issuer or a related person is required to redeem or purchase the stock (within such 20 year period and not subject to such a contingency); (iii) the issuer or a related person has the right to redeem or purchase the stock (which right is exercisable within such 20 year period and not subject to such a contingency) and as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. There are exceptions for certain rights that are exercisable only on the death, disability or mental incompetency of the holder, or only upon the separation from service of a service provider who received the right as reasonable compensation for services, and for certain situations involving publicly traded stock.

Nonqualified preferred stock is treated in the same manner as securities under section 351 and thus is not qualified consideration that may be received tax free by a contributing shareholder. Sections 354(a)(2)(C) and 356(e) treat nonqualified preferred stock as taxable consideration if received in exchange for stock by shareholders of a corporation that itself is a party to a reorganization (except to the extent received in exchange for other nonqualified preferred stock); and section 355 contains a similar rule (sec. 355(a)(3)(D)).