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Descriptions of Foreign Tax Provisions

Foreign Tax Splitting

In certain cases, the person who has legal liability for a foreign tax may be different than the person who realizes the underlying income; for example, when there are subsidiaries and parent companies. In these cases, there is “separation” or “splitting” of foreign taxes from the foreign income to which the taxes relate. Taxes are “suspended” until year in which the income is repatriated. U.S. corporations that own part of foreign corporations may defer U.S. taxes on the income generated by the foreign entity until the earnings are repatriated. However, the U.S. company can include the foreign taxes paid by that entity in its foreign tax credit calculation immediately because the entity is treated as a partnership in the foreign country. The extenders bill prevents the foreign tax credit from being taken until the foreign income is repatriated into the U.S.

Covered asset acquisitions

When a corporation wants to buy an interest in another corporation, it often prefers to obtain the assets of the target entity rather than stock in the target entity. Companies have to report the difference in value before and after the purchase of the asset for the qualified portion under U.S. law, in accordance with the schedule provided by U.S. law. Buyers can benefit from the assets' depreciation. If the target entity is a foreign company, the buyer can depreciate assets in a company that is has acquired, even if these assets have already been depreciated by the foreign company. This increases its foreign tax credits beyond the foreign taxes it actually pays. The extenders bill would deny foreign tax credits for “covered asset acquisitions.”

“Hopscotch Rule”

Section 956 is an “anti-abuse” rule that was originally designed to prevent taxpayers from accessing earnings by controlled foreign corporations (CFC) without actually repatriating those earnings. To achieve this goal, section 956 treats certain CFC actions as “investments in U.S. property,” including: loans to the U.S. parent, guarantees of parent debt, ownership of U.S. real estate, ownership of U.S. intangible property, etc. This provision limits the amount of these transactions that can be counted as foreign taxes paid in order to receive foreign tax credits.

80/20 Rule

In general, dividends and interest paid by a U.S. person are counted as U.S. source income to recipient and subject to the 30 percent withholding tax if paid to a foreign person. However, a company is not required to withhold if at least 80 percent of the gross income of a resident alien individual or domestic corporation is foreign source and attributable to active conduct of a foreign trade or business. Interest income is sourced as foreign; dividend income is counted as coming from a U.S. source, but is exempt from withholding tax. This provision repeals the 80/20 rules for resident alien individuals and U.S. corporations that meet the 80/20 test for taxable years beginning after December 31, 2010, and grandfathers in certain companies.