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International Provisions of the Jobs Creation Act

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The American Jobs Creation Act of 2004 (AJCA) was signed into law on October 22, 2004. One of the major areas of reform in the Act was U.S. taxation of international activities. This column provides an overview of these changes.

Foreign Taxes

Formerly, excess foreign taxes from the current year were carried back two years and forward five years. The AJCA, however, now provides that excess foreign tax credits will be carried back one year and forward 10 years, increasing the window of surrounding years from seven to 11 and effectively adding five years of potential carryover to credits that were facing their fifth (and previously final) year of carryover potential in 2004. In addition, the AJCA amends the alternative minimum tax (AMT) rules to provide that the former limit—which only allowed a 90% offset of AMT with foreign tax credits—has been removed, and the full credit can be used.

Prior to the AJCA, accrual-basis taxpayers were required to translate foreign taxes paid into dollars using the average exchange rate for the year. The new rule provides that taxpayers may elect to use the exchange rate when paid, as long as the method is applied consistently. In addition, future regulations are to address the use of such an election for qualifying business units (QBU). A QBU is basically a corporation or branch of a corporation that operates in a foreign economy and maintains its books using that foreign currency. This change is effective for taxable years beginning after December 31, 2004.

The Act provides that no foreign tax credit is available for income or gains (other than dividends) if the property is held for 15 days or less in the 31-day period that surrounds the right to receive the payment or if the holder is required to make related payments (such as a short sale). Dealers in a given type of property aren't subject to this limitation with respect to their stock in trade. This rule is effective for amounts paid or accrued more than 30 days after enactment.

Beginning in 2007, the number of foreign-source income baskets is reduced from nine to two: passive and general limitation. The passive basket will continue to include portfolio income items (except for businesses predominantly engaged in banking and insurance), dividends from a DISC (Domestic International Sale Corporation) or FSC (Foreign Sales Corporation), and foreign trade income.

Earnings Repatriation

Although the U. S. tax system generally taxes worldwide income, U. S. domestic corporations aren't required to recognize income earned by foreign corporate subsidiaries until such income is paid to the U. S. parent as a dividend. (Unless, of course, the rules of penalty provisions such as Subpart F apply.) As a result, there exists an incentive for companies to continue to reinvest in overseas operations rather than pay the difference between the U.S. tax rate and the foreign rate. In effect, the earnings are trapped overseas, creating what some call an incentive to outsource at the potential expense of reduced U. S. domestic employment. To address this, the AJCA creates an 85% temporary dividends-received deduction

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(TDRD) for dividends paid to U. S. domestic parent corporations. For a company in the 35% tax bracket, the 85% TDRD effectively makes the tax rate on repatriation approximately 5%. This deduction is available either for the taxpayer's last taxable year before the date of enactment or the taxpayer's first taxable year that begins during the one-year period after the date of enactment.

There are three significant limitations on this deduction. First, the dividend must be "extraordinary." Extraordinary dividends are defined as cash dividends in excess of the average dividend paid over the previous five-year period, disregarding the highest year and the lowest year. Second, the deduction is restricted to the greater of $500 million or the relevant amount disclosed on the corporation's last audited financial statements as permanently reinvested outside the United States. Third, the dividend must be invested pursuant to a domestic reinvestment plan approved by the company's top officers and board of directors. Such plans may include, but aren't limited to, funding for worker hiring and training, infrastructure, research and development, capital investment, or financial stabilization. The dividends may not be used for executive compensation or other prohibited items. Initial guidance has been provided in Notice 2005-10, Domestic Reinvestment Plans and Other Guidance Under Section 965.

Corporate Inversions

Increased attention has been given to the issue of corporate inversions in which a domestic corporation (or partnership) is essentially replaced by a foreign corporation to allow the foreign source income to escape U.S. taxation. For inversions after March 4, 2003, this tax advantage is limited or prevented. If the the former shareholders own 80% of the foreign entity, the corporation will be subject to U.S. tax as if it were a domestic corporation. In cases where the former shareholders own between 60% and 80% of the stock, there is a 10-year period in which any inversion gain would be taxed. This type of transaction can't be avoided through tax treaties.

Individual Expatriation

In an effort to strengthen the rules designed to prevent expatriation for tax avoidance purposes, individuals who expatriate and have an average tax of $124,000 (to be indexed for inflation) for five years before the loss of U.S. citizenship or who have a net worth of more than $2 million (or those who don't certify that they are in compliance with all U. S. tax requirements) are subject to taxation on their U.S. source income at the rates applied to U.S. citizens and residents. Limited exceptions exist for dual citizens and minors. Also, during the 10-year period following expatriation, if the individual returns to the U.S. for more than 30 days during a calendar year, the individual is subject to taxation as if he or she were still a U.S. citizen.

Other Provisions

The rules related to foreign personal holding companies (FPHC) and foreign investment companies (FIC) have been repealed, and the AJCA makes a number of housekeeping changes to the Subpart F provisions of the IRC to prevent abuses. Other changes not specifically described above include a broader definition of "effectively connected income" in IRC Section 864, the addition to IRC Section 904 of a new foreign tax credit requirement to recapture overall foreign losses upon sale of stock in a controlled foreign corporation unless an exception can be met, and an amendment of IRC Section 332 detailing how certain holding companies in liquidation will no longer receive liquidation treatment.

The AJCA has made substantial changes to the international tax rules. Managers engaged in multinational operations should take careful note of the particular rule changes affecting their business and consult with their tax advisor when necessary. ■

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