



International Partnerships, Joint Ventures and Hybrids

By Giovanna T. Sparagna



IRS Closes Technical Loophole to Eliminate Foreign Tax Credit Planning with Stapled Stock

On July 23, 2003, the IRS released Notice 2003-50,¹ closing down a foreign tax credit planning technique that involved the use of a “stapled” foreign corporation as defined in section 269B of the Internal Revenue Code (“the Code”).² A stapled foreign corporation is an entity with a specified level of its stock “stapled” to the stock of a domestic corporation. Under Code Sec. 269B, two corporations are “stapled” if more than 50 percent in the value of the beneficial ownership in each of such entities consists of stapled interests. Stapled interests include interests, where by reason of, form of ownership, restrictions on transfer or other terms or conditions, in conjunction with the transfer of one interest, the other interest is, or is required to be, transferred. A stapled foreign corporation is treated as a domestic corporation for most, but not all U.S. tax purposes (dual tax characterization). As more fully discussed below, the dual tax characterization of the stapled foreign corporation afforded U.S. multinationals the opportunity to form a “nonaffiliated” (deemed) domestic corporation therein (without having to divest any stock interest in).

The benefit of nonaffiliated/disaffiliated³ status is that it permits a U.S. group to segregate foreign source income in a domestic entity that will compute its foreign tax credit limitation on a separate company basis (*i.e.*, without regard to any tax attributes of the U.S. group). The foreign tax credit limitation determines the amount of foreign tax credit available to offset U.S. tax. If a corporation is in an excess foreign tax credit position, it will want to augment the amount of its foreign source income.⁴ A disaffiliated domestic corporation will avoid any reduction in its foreign source income attributable to the group interest allocation rules,⁵ and the consolidated overall foreign loss (COFL) provisions.⁶ Depending on the tax attributes of the U.S. group, disaffiliation will augment the utilization of foreign tax credits since

no interest expense of the U.S. group will be allocated and apportioned to the foreign source income of the disaffiliated domestic entity. Similarly, the foreign source income of a domestic affiliate will not be resourced as U.S. source income on account of a COFL of the U.S. consolidated group. In sum, a disaffiliated domestic corporation can minimize U.S. tax on foreign source income of a related group (affiliated and nonaffiliated).

The Saga of Stapled Stock Abuses

The dual tax character of a “stapled” foreign corporation is an historical anomaly resulting from the use of stapled stock in tax planning and Congressional and IRS reaction to such planning. Code Sec. 269B was enacted in 1984⁷ in response to the use of stapled stock in conjunction with a transaction to “decontrol” a CFC in order to avoid the application of the subpart F rules.⁸ In that transaction, a U.S. corporation would spin off a CFC to its public shareholders, and simultaneously staple the former CFC stock to stock of the U.S. public company.⁹ Despite divestment through the spin-off transaction, the IRS and Congress generally believed that the stapling transaction allowed U.S. management to retain control of the former CFC and inappropriately avoid subpart F.¹⁰ Code Sec. 269B addresses this abuse by treating a stapled foreign corporation as a domestic corporation and thereby, subject to worldwide U.S. taxation. Moreover, viewed as a domestic corporation, the stapled foreign corporation would constitute

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a U.S. shareholder (within the meaning of Code Sec. 951(b)) and would be required to include the subpart F income of any lower-tier foreign subsidiaries.

As a consequence of its “domestic” status, however, a stapled foreign entity might be eligible to join in the filing of a consolidated return with other domestic corporate affiliates. Only an *includible* corporation (meeting certain ownership thresholds¹¹) can be a member of an *affiliated group* that is eligible to join in the filing of a consolidated return.¹² An includible corporation is any corporation except those corporations specified in Code Sec. 1504(b). Code Sec. 1504(b)(3) excludes all foreign corporations from the definition of an includible corporation. Since, however, the stapled foreign entity was treated as a domestic entity for all purposes of the Code, it would be defined as an includible corporation within the meaning of Code Sec. 1504(b) and eligible to join in the filing of a consolidated return (assuming the threshold stock ownership level was also met).

Given the potential revenue drain if a stapled foreign entity was permitted to share its foreign source losses with a U.S. consolidated group, the IRS issued Notice 89-94.¹³ The notice held that, in regulations to be issued, a “U.S.-owned”¹⁴ stapled foreign entity would retain its character as a foreign corporation for purposes of applying Code Sec. 1504(b). Thus, although the stapled foreign entity would be a domestic corporation for all other purposes, it would be ineligible to join in the filing of a consolidated return.

Domestic/Nonaffiliated Status Provided Foreign Tax Credit Opportunities

Of course, it did not take long before new techniques were designed to exploit a stapled foreign corporation’s (deemed) domestic, but nonaffiliated status. The beauty of the stapled stock structure was that nonaffiliation could be achieved simply by linking the transferability of shares in related foreign and domestic entities. By comparison, all other “internal” disaffiliation structures had been eliminated by Code Sec. 904(i). Before Code Sec. 904(i), disaffiliation of a domestic entity was attempted by interposing nonincludible entities between the domestic group and the hoped-for disaffiliated domestic entity.¹⁵ Recognizing the potential to avoid the foreign tax credit limitation rules by the simple expediency of interposing a related “nonincludible” domestic entity in an otherwise affiliated chain of corporations, the Treasury was granted broad authority in Code Sec. 904(i) to draft rules to resource “the income of any

member of an affiliated group of corporations (defined to include certain groups that would otherwise not be treated as affiliated because stock of includible corporations is owned, *indirectly*, rather than directly, by other includible corporations),” or to modify the consolidated return regulations to prevent the avoidance of the foreign tax credit limitation rules. After Code Sec. 904(i), a disaffiliation transaction sufficient to avoid the group interest allocation rules, COFL rules¹⁶ and Code Sec. 904(i) generally would require a divestiture of more than 20 percent of an interest in the domestic corporation to third parties.¹⁷ The problem for the IRS was that the Code Sec. 904(i) regulations were drafted, in relevant part, to address *disaffiliation by interposing nonaffiliated entities*.¹⁸ Such rules did not contemplate disaffiliation based on the dual tax character of a foreign entity such as that created for a stapled foreign corporation in Notice 89-94. It is ironic that the culmination of these various anti-abuse concerns led to rules that formed the basis for using a stapled foreign corporation to augment a corporation’s foreign tax credit limitation.

The paradigm planning structure using the stapled stock technique is exemplified by the structure analyzed in FSA 200233016.¹⁹ There, Parent, a domestic corporation owned all of Sub 1, which in turn, owned all of Sub 2, which in turn, owned all of Sub 3, which in turn, owned all of Sub 4. Each of Subs 1 through 4 was a domestic corporation that joined in the filing of Parent consolidated federal income tax return. Sub 3 also owned several chains for controlled foreign corporations (Sub3 CFCs). Since the Parent group had a “substantial” CNOL, Parent deducted foreign taxes rather than elect the credit.

In order to “facilitate the efficient financing and cash management” of Sub 3 and its foreign subsidiaries, the following reorganization was implemented. In step one, Sub 3 formed a new wholly owned foreign corporation (“Holding”) to which Sub 3 transferred all of the shares of the Sub3 CFCs in a transaction intended to qualify under Code Secs. 351 and/or 368(a)(1)(B) (“the Holding Reorganization”).²⁰ In step two, the corporate articles of Holding and Sub 4 were amended to include a reciprocal transfer restriction on shares (“the Stapling Reorganization”). As a result, no shares of either corporation could be transferred unless an equal amount of shares of the other corporation (Sub 4 or Holding, whatever the case may be) were also transferred.

For the year that included the transaction, Holding filed a separate U.S. tax return on which it reported

foreign source dividend and interest income and subpart F income from Sub3 CFCs. Holding applied associated foreign tax credits to offset the U.S. tax on its foreign source income. In later years, Holding claimed “substantially larger amounts” of foreign tax credits for deemed-paid taxes related to subpart F income of the Sub3 CFCs.

There is not much discussion as to Parent’s legal position. However, Parent presumably viewed the reciprocal transfer restrictions on Holding and Sub 4 stock as subjecting Holding to Code Sec. 269B.²¹ As a “stapled” foreign corporation, Holding would be treated as a domestic corporation subject to worldwide U.S. taxation. Although treated as a domestic corporation, Holding was not treated as a member of the Parent group based on the holding in Notice 89-94.

Notice 89-94—The Unintended Technical Fallout

Although the exclusion of stapled foreign corporations from the consolidated return may have been specifically contemplated in legislative history, the IRS later discovered that the holding in Notice 89-94 had several *unintended* technical consequences on provisions related to the foreign tax credit—more specifically, the Code Sec. 864(e) group interest allocation rules and the Code Sec. 904(f) overall foreign loss rules the applications of which are directly linked to the definition of an “includible corporation” under Code Sec. 1504(b).

Under Code Sec. 864(e)(5)(A), the *affiliated group* that is required to allocate and apportion interest is defined by reference to Code Sec. 1504. The group interest expense provisions were enacted in 1986 and premised on the notion that money is fungible. Prior to this time, the allocation of interest expense was computed on an entity-by-entity basis. Controlled groups could avoid an allocation of interest expense against group foreign source income by segregating the borrowing in one entity and the foreign source income in another entity. After enactment of Code Sec. 864(e), all members of the affiliated group as defined in Code Sec. 864(e)(5) must allocate interest expense as if a single corporation. The term “affiliated group” was defined as in Code Sec. 1504 (*i.e.*, possession of at least 80 percent of the total voting power of, and total value in, a corporation).²² As

noted earlier, Code Sec. 1504(b)(3) specifically excludes a foreign corporation from the definition of an includible corporation. Using the facts of the FSA (by way of example only since there was no discussion in the FSA that the IRS considered interest allocation an issue in the case), if Holding were a stapled entity, it would fall outside the affiliated group definition pursuant to the holding in Notice 89-94. Accordingly, Holding could allocate and apportion interest expense on a separate entity basis and avoid group interest expense rules.

Similarly, since Holding could not be a member of Parent consolidated group, the COFL rules would not apply to resource the foreign source income of Holding. An overall foreign loss occurs where a taxpayer’s allocated and apportioned expenses to foreign source income exceed its foreign source income for the year. The historic example that led to the enactment of an OFL regime was the foreign branch situation where branch losses exceeded branch income and the excess branch loss would offset domestic source income of

the domestic owner of the branch. If the foreign branch started to report profits, a domestic owner would be able to offset U.S. tax on the foreign source profits with available foreign tax credits. Alternatively, once profitable, the domestic owner of a foreign branch

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could also incorporate the branch activities in a foreign corporation so as to obtain deferral on future profits. Code Sec. 904(f) was enacted to essentially match, for foreign tax credit purposes, the excess foreign loss of an entity with subsequently accrued net positive foreign source income. Operationally, this is accomplished by resourcing foreign source income as U.S. source income under Code Sec. 904(f)(1)²³ and by triggering gain (but not loss) on any *disposition* of foreign branch trade or business assets (giving rise to the loss) under Code Sec. 904(f)(3).²⁴ For consolidated groups, these principles are applied on a *group* basis to trigger recapture of overall foreign losses accrued by any affiliate in the group.²⁵

Under current rules, an overall foreign loss can be created even where there are no foreign branch operations. In corporate groups with significant interest expense, a COFL can be largely attributable to the group interest apportionment and allocation rules under Code Sec. 864(e). Interest expense for

the entire “affiliated group” is allocated to foreign source income based on an apportionment ratio determined by the ratio of the group’s foreign assets as a percentage of total group assets (as if all members of the affiliated group were a single corporation).²⁶ Allocated interest expense in excess of foreign source income would create an overall foreign loss subject to the Code Sec. 904(f) recapture rules.

In the FSA transaction, the nonaffiliation of Holding shielded its foreign source income from the recapture provisions that would apply to Parent’s COFL because on a separate entity basis, Holding did not have any overall foreign loss. In addition, the transfer of the Sub3 CFCs to the newly formed Holding was a transaction that neither triggered gain under Code Sec. 904(f)(3)²⁷ nor required an allocation of any portion of the COFL.²⁸

Finally, although the IRS has broad authority under Code Sec. 904(i) to draft regulations to prevent the use of deconsolidation transactions to avoid foreign tax credit limitations, no regulations were drafted to bridge the technical gap created by Notice 89-94 since the Code Sec. 904(i) rules also define affiliates to consist of “includible corporations” as defined in Code Sec. 1504.²⁹ On the facts of the FSA, treating Holding as a foreign corporation for purposes of Code Sec. 1504(b) resulted in avoiding the Code Sec. 904(i) anti-avoidance regulations.

IRS Strategy to Eliminate Stapled Stock Benefits

In the FSA, the IRS realized that Notice 89-94 had conferred unintended benefits in the foreign tax credit area. If Code Sec. 269B applied, a stapled foreign corporation would potentially be able to compute its foreign tax credit limitation on a separate company basis in contravention of the policy and purposes underlying Code Secs. 864(e), 904(f) and 904(i). Notice 2003-50 closes the technical loophole created by Notice 89-94. Accordingly, the notice announces that regulations will be drafted under Code Sec. 269B under which a stapled foreign corporation will be treated as an includible corporation when applying Temporary Reg. §§1.861-11T(d)(6) and 1.904(i)-1.³⁰

In making the changes prospective only,³¹ the IRS is arguably acknowledging the validity of the

technical positions under Code Secs. 864(e) and 904(i) after Notice 89-94. However, the IRS warns that it may challenge pre-effective date transactions with its arsenal of existing anti-abuse doctrines and provisions such as a substance-over-form analysis (including whether to disregard transfer restrictions on the stock of 80-percent subsidiaries). In addition, Notice 2003-50 notes that the IRS intends to issue guidance under Code Sec. 269B to address the stapling of corporations held by the same person or related persons (presumably, as to whether the restrictions on internally held shares creates true stapled interests).

The FSA foreshadows the types of pre-effective date arguments that the IRS might employ. The lack of a credible business purpose lays the foundation for several arguments. In the FSA, the alleged business purpose of “efficient” financing and cash management was questioned since the IRS agents determined

that the Year X through Year X+2 financial information for Sub 3, Holding, and the Sub3 CFCs “shows substantial shareholder equity and an absence of debt with third party lenders.” Moreover, the business motive may have been subjected to additional scrutiny since the IRS believed that a similar

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transaction was marketed to Parent as a tax manipulation strategy: “In particular, by forming Holding and moving the ownership of the Sub3 CFCs outside the Parent Group, the Parent Group appears to have the circumvention of the controlled group’s overall foreign loss limitations under section 904(f) as the primary purpose of the Year X Reorganization.”

If the principal purpose of the restructuring in which Holding was formed was motivated by a tax avoidance, Code Sec. 269 may, the IRS asserts, potentially apply (to deny Holding the use of any foreign tax credits). In addition, the transfer of the Sub3 CFCs to Holding could be taxable if the transaction lacked the requisite business purpose required for Code Secs. 351 and 368(a)(1)(B). Similarly, a purported “tax avoidance” purpose could permit the IRS to invoke Code Sec. 482. Citing Code Sec. 482/351 precedents,³² the IRS noted that it may be able to disregard the reorganization (*i.e.*, the transfer of stock in the Sub3 CFCs to Holding) and reallocate back to Sub 3 the dividend and interest income (presumably

the subpart F income as well) from the Sub 3 CFCs. (If allocated to Sub 3, the group interest allocation rules and the overall foreign loss rules would apply to limit the foreign tax credit on the foreign source income.) Finally, the IRS notes that the effectiveness of the “stapling” transaction itself may be subject to challenge based on unspecified state law grounds. Given the lack of evidence on the business purpose for the stapling transaction, the stapling transaction may also be subject to challenge under Code Sec. 269 and sham transaction principles.

Anti-Abuse Solutions Create Technical “Hell”

Notice 2003-50 very clearly shuts the door on the use of the stapled stock for foreign tax credit planning. Moreover, pre-effective date structures will likely be scrutinized for the existence of a valid business purpose and economic substance. Unfortunately, Notice 2003-50 creates a technical mess by proposing exceptions to exceptions with very little policy underpinnings. This “half-fix” is endemic of an already “broken” foreign tax credit regime. Corporations have engaged in these and similar transactions, in part, to alleviate the burdens on many U.S. multinational

corporations to manage (and if possible, avoid) excess foreign tax credits. The increasing excess foreign tax credit burden is attributable, in part, to the numerous post-1986 foreign tax credit provisions enacted by Congress—such as an increase to nine foreign tax credit baskets under Code Sec. 904, the U.S. group interest expense allocation rules under Code Sec. 864(e), the Code Sec. 904(f) rules to recapture overall foreign losses, and the alternate minimum tax (AMT) limitation. However, the cruelest limitation of all (at least conceptually) is the short window for utilizing the foreign tax credit in a system that is biased towards creating excess foreign tax credits—a two-year carry back period and a five-year carry forward period.

Congress has recognized the failings of the foreign tax credit regime but any comprehensive reform is uncertain.³³ In the meantime, taxpayers have utilized planning techniques such as the stapled stock transaction to absorb foreign taxes paid on foreign source income. With no where else to turn, foreign tax credit planning transactions and IRS rules responding to those transactions will simply get so complex that the system will surely collapse under the sheer weight of incomprehensible foreign tax credit rules.

ENDNOTES

¹ Notice 2003-50, IRB 2003-32, 295 (Aug. 11, 2003).

² Unless otherwise stated, all references to the Code are to the Internal Revenue Code of 1986.

³ This article may use disaffiliation and nonaffiliation interchangeably although as a technical matter, the stapled foreign entity is nonaffiliated and cannot be regarded as disaffiliated since it is not *initially* part of the affiliated group.

⁴ The amount of the credit is determined by a notional computation of the U.S. tax on foreign source income.

⁵ Code Sec. 864(e) requires domestic members of an affiliated group to apportion and allocate interest expense to foreign source income on a group basis. Mechanically, the interest expense of the affiliated group is allocated to foreign source income based on the group's ratio of foreign assets (or foreign source income) to total affiliated assets (or total income). Reg. §1.861-11.

⁶ Code Sec. 904(f) provides rules for calculating, maintaining and recapturing overall foreign loss accounts. In general, an overall foreign loss is created if a taxpayer's gross foreign source income exceeds the expenses properly allocated and apportioned thereto (determined on a basket-by-basket basis). See Reg. §1.904(f)-1(c). For consolidated groups, the COFL is calculated on a combined basis. See Reg. §1.1502-9(b).

⁷ Act Sec. 136(a) of the Deficit Reduction Act of 1984 (DRA) (P.L. 98-369).

⁸ “Decontrolling” refers to a *disposition* of an amount of stock in the foreign corporation, which is sufficient to cause such entity to fail to meet the definition of a controlled foreign corporation under Code Sec. 957 (*i.e.*, U.S. shareholders own greater than 50 percent of the voting in, or value of, a foreign corporation).

⁹ See *e.g.*, Rev. Rul. 80-213, 1980-2 CB 101 (wherein the IRS considers the valuation aspects of such a transaction).

¹⁰ See DRA, Report of the Committee of Conference (“the Conference Rpt.”), H.R. REP. NO. 98-861 (June 23, 1984), at 964.

¹¹ In order to be part of an affiliated group, a corporation must be an *includible* corporation and at least 80 percent of its voting power and stock value must be held by other includible corporations meeting the stock ownership requirements (“affiliated status”).

¹² Code Sec. 1504(a).

¹³ Notice 89-94, 1989-2 CB 416.

¹⁴ Code Sec. 269B(e).

¹⁵ Affiliation status for an otherwise “includible corporation” will generally be broken by interposing nonincludible corporations in its chain of ownership (*i.e.*, 80-percent vote and value is not held by includible corporations).

¹⁶ There are also anti-abuse rules in the COFL regulations addressing deconsolidation and similar techniques to avoid the overall foreign loss rules. See Reg. §1.1502-9(c)(2)(v).

¹⁷ See *e.g.*, Lee Sheppard, *Ford Avoids Interest Expense Allocation*, TAX NOTES, OCT. 30, 1989, at 531.

¹⁸ See Reg. §1.904(i)-1(b)(1)(A).

¹⁹ FSA 200233016 (May 9, 2002).

²⁰ Although the transfer of assets in a nontaxable transaction can trigger a recapture of a COFL under Code Sec. 904(f)(3), the transfer of stock in the Sub 3 CFCs would not trigger recapture of the COFL because stock is not regarded as property “which has been used predominantly outside the United States in a trade or business.” Reg. §1.904(f)-2(d)(5)(ii). Several legislative proposals would apply Code Sec. 904(f)(3) to the transfer of stock in a foreign corporation. See *e.g.*, Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27), H.R. CONF. REP. NO. 108-126, at 128 (where section 347 of the Senate bill was rejected in Conference).

²¹ *Compare* Rev. Rul. 89-103, 1989-2 CB 65 (wherein F, a foreign corporation, and D, a domestic corporation, were determined to constitute stapled entities. A foreign shareholder group owned 50 percent of F and D and a U.S. shareholder group owned the remaining 50-percent interest in each of F and D. Both shareholder groups agreed to a re-

- ciprocal restriction on the transfer of an equal amount of shares F and D. Concluding that F was not foreign owned (within the meaning of Code Sec. 269(B)(e)), the stapling transaction was deemed to create an inbound reorganization under Code Sec. 368(a)(1)(F) and subject to any applicable toll charges under Code Secs. 367 and 897.
- ²² For these purposes, the definition of an includible corporation is determined without regard to the exclusion under Code Sec. 1504(b)(4) (*i.e.*, corporations subject to a Code Sec. 936 election). In addition, the definition is further broadened to include certain foreign corporations with significant U.S. effectively connected income. See Temporary Reg. §1.861-11T(d)(6).
- ²³ In general, the amount of foreign source income subject to recapture is the lesser of the net amount of accumulated overall foreign losses or 50 percent of the foreign taxable income in the tax year. A taxpayer can elect to recapture more. See Code Sec. 904(f)(1) and Reg. §1.904(f)-2(a) and -2(c)(2).
- ²⁴ If a taxpayer with an overall foreign loss trigger a gain subject to the Code Sec. 904(f)(3) recapture rules, Code Sec. 904(f)(1) will first be applied to resource such income as U.S. source. The remaining gain will be resourced without limitation up to 100 percent of the balance in the overall foreign loss account.
- ²⁵ See, *e.g.*, Reg. §1.1502-9(b). The U.S. group computes its consolidated separate limitation loss for each foreign tax credit basket by aggregating each member's foreign source taxable income or loss.
- ²⁶ Temporary Reg. §1.861-11T(c).
- ²⁷ The transfer of stock is not regarded as an asset used in a trade or business and its disposition does not trigger Code Sec. 904(f)(3). See Reg. §1.904(f)-2(d)(5)(ii). *Supra* note 19.
- ²⁸ See Reg. §1.1502-9(c)(2) (applicable to "departing members" of a consolidated group).
- ²⁹ As currently drafted, those rules are primarily directed towards "deconsolidation" transactions where nonincludible entities are interposed between otherwise includible entities. On the facts of the FSA, these rules would have no application.
- ³⁰ Reg. §1.904(i)-1 requires members of an affiliated group to determine the total available foreign tax credit on a group basis (combining separate limitation loss accounts of all members and applying the COFL rules as if all affiliates were members of a single consolidated group).
- ³¹ The Code Sec. 269B regulations will be effective for tax years beginning after July 22, 2003, except that for structures completed on or after July 22, 2003, the regulations will be effective for the tax year that includes July 22, 2003.
- ³² See Reg. §1.482-1(f)(1)(iii) and *National Securities Corp.*, CA-3, 43-2 USTC ¶9560, 137 F2d 600, *aff'g*, 46 BTA 562, Dec. 12,432 (1942), *cert. denied*, SCT, 320 US 794, 64 SCT 262 (1943) (stock with a built-in loss was transferred to a transferee corporation in Code Sec. 351 transaction; losses recognized by transferee corporation on sale of stock were reallocated to transferors).
- ³³ The Senate and House have pending bills (S. 1637 and H.R. 2896, 108th Cong. (2003)) with provisions that will lessen the *bite* of the current tax credit provisions. For example, both bills propose broadening the group interest allocation provisions to include the worldwide affiliated group (section 205 Senate, section 1081 House), eliminate the 90-percent AMT limitation on foreign tax credits (section 203 Senate, section 1031 House), and recapture an overall domestic loss as foreign source income (section 204 Senate, section 1082 House). The House bill additionally proposes to reduce the number of foreign tax credit baskets from nine to two (section 1083) and the Senate bill proposes to increase the carryover period for the foreign tax credit from five to 10 years, but reduce the carry back to one year (section 201).

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