New Law Limits
Code Sec. 956 Hopscotch Rule

Recent legislation modifies the “hopscotch” rule that applies for purposes of subpart F. The new rule would limit the amount of foreign tax credits that accompany a subpart F inclusion resulting from an investment in U.S. property.

Code Sec. 951(a)(1)(A) requires U.S. shareholders of a controlled foreign corporation (CFC) to include in their gross incomes their pro rata shares of the subpart F income of the CFC. In addition, Code Sec. 951(a)(1)(B) requires U.S. shareholders of a CFC to include in their gross incomes the amounts determined under Code Sec. 956 resulting from investments by the CFC in U.S. property.

Under the so-called hopscotch rule, amounts included in the income of U.S. shareholders under subpart F are deemed distributed directly to them; i.e., the deemed distribution “hops” over any intervening CFCs. Importantly, Code Sec. 960(a)(1) provides that the deemed paid taxes that accompany the inclusion are calculated based only on the lower-tier CFC’s earnings and profits and taxes pools.

For example, assume that a U.S. company (“USP”) owns all of the stock of CFC1, organized in Country A, which in turn owns all of the stock of CFC2, organized in Country B. CFC1 has post-1986 undistributed earnings of $200U and post-1986 foreign income taxes in the amount of $10. CFC2 has post-1986 undistributed earnings of $100U and post-1986 foreign income taxes of $50. CFC2 makes a loan to USP that constitutes an investment in U.S. property resulting in a Code Sec. 951(a)(1)(B) inclusion in the amount of $100U. The inclusion is deemed distributed directly by CFC2 to USP. Accordingly, the amount of the deemed paid tax credits accompanying the inclusion would be $50 (100U/100U x $50).

The legislation adds Code Sec. 960(c) limiting the amount of foreign tax credits that accompany an inclusion under Code Sec. 951(a)(1)(B). The limitation is determined by calculating a U.S. shareholder’s deemed paid foreign tax credits as if cash in an amount equal to the amount of the Code Sec. 951(a)(1)(B) inclusion were distributed as a series of distributions through the chain of ownership, which begins with such CFC and ends with the U.S. shareholder (“hypothetical credit”). If this amount is less than the taxes deemed paid by the U.S. shareholder without regard to the new rule (the “tentative credit”), then the amount of the U.S. shareholder’s credit would be the hypothetical credit.
Under the above example, the hypothetical credit is calculated as if the 100u were distributed by CFC2 to CFC1, and then by CFC1 to USP. The deemed distribution by CFC2 to CFC1 would increase the post-1986 undistributed earnings of CFC1 from 200u to 300u, and increase the post-1986 foreign income taxes pool from $10 to $60. The 100u deemed distributed by CFC1 to USP would result in a deemed paid tax credit of $20 (100u/300u x $60). Because the $20 hypothetical credit is less than the $50 tentative credit, USP’s foreign tax credit would be limited to $20. After the inclusion, CFC2 would have 100u of previously tax income, zero post-1986 undistributed earnings, and $30 post-1986 foreign income taxes.

If the hypothetical credit exceeds the tentative credit, then the deemed paid credit is the tentative credit. For example, if CFC1 had $175 of taxes associated with its 200u of earnings, the hypothetical credit would be $75 (100u/300u x $225). Under these facts, the credit would be $50 (i.e., the tentative credit). A taxpayer that desires to increase its foreign tax credits could distribute the $100 through CFC1 and bring back the greater amount of deemed paid taxes. On the other hand, the new rule would not impede the use of Code Sec. 956 to access low-taxed earnings of lower-tier CFCs to absorb expiring foreign tax credits.3

Any withholding taxes that countries A or B might have imposed on a distribution up through the chain of ownership would not be taken into account. If withholding taxes are imposed when the previously taxed income is subsequently distributed, such taxes would accompany the distribution.4

The JCT Explanation describes the results where CFC1 also distributes to USP all of its earnings during the same year. It indicates that the hypothetical credit calculation would be identical in this case by effectively ignoring CFC1’s distribution. This result would appear to be computationally incorrect, in that the entire 300u of earnings of CFC1 and CFC2 would have been distributed, but $30 of taxes associated with such earnings would not be available as a credit. It seems obvious that the rules should be applied in a manner that causes all of the foreign taxes associated with the distributed earnings to accompany the earnings.5

The hopscotch rule would continue to apply for purposes of determining the amount of the inclusion. For example, if the amount of CFC2’s earnings were 80u rather than 100u, the amount of the Code Sec. 951(a)(1)(B) inclusion would be the 80u of CFC2’s earnings. Furthermore, the new rule would not apply to inclusions of subpart F income under Code Sec. 951(a)(1)(A).

This new rule is somewhat perplexing. The hopscotch rule allows the taxes associated with the particular earnings of a lower-tier CFC to accompany the corresponding earnings, which is consistent with the fundamental policy of the foreign tax credit provisions and the other proposed amendments. Such a rule provides flexibility in organizing foreign operations to accommodate business needs (e.g., using holding companies). The additional complexity does not seem to warrant any perceived “loop-hole” closing benefits.

The new rule as initially introduced would generally have been effective for investments in U.S. property made after May 20, 2010 (i.e., date of introduction). As enacted, the provision is effective for acquisitions of U.S. property after December 31, 2010.

**Endnotes**

1 P.L. 111-226; see Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to the House Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010 (JCX-46-10), Aug. 10, 2010, at 20-26 (“JCT Explanation”).


4 Code Sec. 960(a)(3), Reg. §1.960-2(e), Reg. §1.904-6(c), Ex. 7.

5 It would be disingenuous for this rule to be applied in a manner such that earnings are subject to U.S. taxation but taxes associated with the earnings are not available as a credit, given that a “matching” rule in the same legislation would deny a credit for foreign taxes until the earnings are subject to taxation (unless “turnabout is fair play” has been adopted as a tax policy goal).