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S.A. 4575 to H.R. 1586

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Summary

While the economy is starting to grow and recover from the worst financial and economic crisis since the Great Depression, a real economic recovery is not possible without long-lasting, meaningful job creation. That's why Senate Democrats are committed to putting America back to work and strengthening our economy. As a part of our year-long, multi-bill jobs agenda, Senate Democrats passed the bipartisan *HIRE Act* (**P.L. 111-147**) and the *Travel Promotion Act* (**H.R. 1299**, as amended) earlier this year. These two bills have the potential to create and save well over a million jobs, strengthen American businesses, and boost our economy.

Continuing this commitment to job creation, on August 2, 2010, Senators **Murray**, **Harkin**, **Reid** and **Schumer** proposed a substitute amendment (**S. A. 4575**) to **H.R. 1586**, the *FAA Air Transportation Modernization and Safety Improvement Act*. The substitute amendment includes support for local school districts to prevent imminent educator layoffs, support for state Medicaid programs, and offsets, including the closure of foreign tax loopholes, which will more than pay for the legislation.

The Senate is expected to consider this amendment the week of August 2, 2010.

Major Provisions

Education Jobs Funding

The amendment would provide $10 billion for additional support to local school districts to prevent imminent layoffs. It is estimated that this fund will help keep nearly 140,000 educators employed next year.

The fund will be administered by the Department of Education. After reviewing State applications, the Department will make formula allocations to States based on total population and school age population. States will then distribute the funds to school districts through their respective funding formulas or based on each district's share of Title I funds. If a Governor does not submit an approvable application for funds to the Department, **S.A. 4575** directs the Secretary to bypass the State government and make awards directly to other entities within the State.

The amendment includes provisions to ensure that States use these funds for the preservation of jobs serving elementary and secondary education. Amounts from the Education Jobs Fund may not be used for purposes such as equipment, utilities, renovation, or transportation. **S.A. 4575** prohibits States from using any of these funds to add to "Rainy-Day Funds" or to pay off State debt.

In order to receive an Education Jobs Fund grant, each State must provide assurance that State spending for both K-12 and higher education (measured separately) in fiscal year 2011 will be at or above either: (1) the fiscal year 2009 level (in aggregate or per pupil); (2) the same percentage share of the total State budget as in fiscal year 2010, or; (3) for states demonstrating especially dire fiscal conditions, the 2006 fiscal year aggregate dollar level or percentage share.

State Fiscal Relief

Under current law, the Federal Medical Assistance Percentage (FMAP) (the federal government's share of Medicaid spending) is increased by 6.2 percentage points for all States, and by additional percentage points for states with high unemployment. These temporary increases were enacted in the *American Recovery and Reinvestment Act* (the *Recovery Act*, **P.L. 111-5**) in February 2009 in response to the increased Medicaid caseloads and decreased state revenues resulting from the recession. The increase is scheduled to expire on December 31, 2010. **S.A. 4575** would continue the additional federal assistance for six months, but would phase the level of assistance down. For January – March, 2011, the federal Medicaid matching rate would be increased by 3.2 percentage points for all States, and for April – June, 2011, the federal Medicaid matching rate would be increased by 1.2 percentage points for all States. For the same six-month period, states with high unemployment would continue to receive the additional percentage points, as they do under current law. This will ensure that states continue to receive increases throughout state fiscal year 2011.

Offsets

Addition of Treatment of Certain Drugs for Computation of Medicaid AMP

Under current law, the calculation of the Medicaid average manufacturer price (AMP) excludes certain payments and rebates if received from or provided to entities other than retail community pharmacies. **S.A. 4575** would provide an exception to that exclusion for inhalation, infusion, instilled, implanted or injectable drugs that are not generally dispensed through retail community pharmacies, to ensure accurate calculation of AMP for these types of drugs.

Food Stamps

Effective March 31, 2014, **S.A. 4575** would return food stamp benefits to the levels that individuals would have received under pre-*Recovery Act* law.

Other Spending Reductions

S.A. 4575 rescinds funding from programs that no longer require funding, have sufficient funding, or have funding that probably cannot be spent before the authority to do so expires. Rescissions include nearly $2.4 billion from *Recovery Act* programs, about $2.3 billion in Department of Defense funds unrelated to current military efforts, and about $2.8 billion from other agencies. The Department of Education's Race to the Top, charter school fund, and the Teacher Incentive Fund are not included among these programs.

Closing Foreign Tax Loopholes

S.A. 4575 would include changes developed jointly by the Treasury Department, the Committee on Ways and Means, and the Senate Finance Committee to curtail abuses of the U.S. foreign tax credit system and other targeted abuses. Foreign tax credits are intended to ensure that U.S.-based multinational companies are not subject to double taxation. However, taxpayers have taken advantage of the U.S. foreign tax credit system to reduce the U.S. tax due on completely unrelated foreign income in a manner that has nothing to do with eliminating double taxation.

Rules to prevent splitting foreign tax credits from income

To prevent double taxation (*i.e.*, full taxation by both a foreign country and by the United States on the same item of income), taxpayers are permitted to claim foreign tax credits with respect to foreign taxes paid on income earned offshore. Taxpayers have devised several techniques for splitting foreign taxes from the foreign income on which those taxes were paid. With these techniques, the foreign income remains offshore and untaxed by the United States, while the foreign taxes are currently available in the U.S. to offset U.S. tax that is due on other foreign source income. In many cases, the foreign income is permanently reinvested offshore such that it likely will never be repatriated and taxed in the U.S. This use of foreign tax credits has nothing to do with relieving double taxation. The President's Fiscal Year 2011 Budget proposes to adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

S.A. 4575 would adopt the President's Budget proposal by implementing a matching rule that would suspend the recognition of foreign tax credits until the related foreign income is taken into account for U.S. tax purposes. The amendment targets abusive techniques and does not affect timing differences that result from normal tax accounting differences between foreign and U.S. tax rules. The provision would apply to all "split" foreign taxes claimed by taxpayers after December 31, 2010.

Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions

There are certain rules that permit taxpayers to treat a stock acquisition as an asset acquisition under U.S. tax law. Taxpayers can obtain similar results by acquiring interests in entities that are treated as corporations for foreign tax purposes, but as non-corporate entities (such as partnerships) for U.S. tax purposes. These transactions ("covered asset acquisitions") result in a step-up in the basis of the assets of the acquired entity to the fair market value that was paid for the stock (or interest in the business entity). In the foreign context, this step-up usually exists only for U.S. tax purposes, and not for foreign tax purposes. As a result, depreciation for U.S. tax purposes exceeds depreciation for foreign tax purposes, such that the U.S. taxable base is lower than the foreign taxable base. Because foreign taxes – and therefore foreign tax credits – are based on the foreign taxable base, there are more foreign tax credits than are necessary to avoid double tax on the U.S. tax base. Taxpayers are using these additional foreign tax credits to reduce taxes imposed on other, completely unrelated foreign income.

S.A. 4575 would prevent taxpayers from claiming foreign tax credits with respect to foreign income that is never subject to U.S. taxation because of a covered asset acquisition. Subject to a transition rule, the provision would generally apply to transactions occurring after December 31, 2010.

Separate application of foreign tax credit limitation to items resourced under tax treaties

To prevent double taxation (*i.e.*, full taxation by both a foreign country and by the United States on the same item of income), taxpayers are permitted to claim foreign tax credits with respect to foreign taxes paid on income earned offshore. To appropriately limit the use of the foreign tax credit system to the avoidance of double taxation, foreign tax credits are limited to the maximum amount of U.S. tax that could be imposed on the taxpayer's foreign source income (*i.e.*, 35 percent of the taxpayer's foreign source income). Taxpayers have devised a technique to

use the U.S. treaty network to enhance foreign tax credit utilization – well beyond what is needed to avoid double taxation – by artificially inflating foreign source income. With this technique, ownership of income-producing assets that would ordinarily be held by U.S.-based multinational companies in the United States (e.g., investments in U.S. securities) is shifted to foreign branches and disregarded entities. This income is often lightly taxed on a net basis by the foreign country, but the treaty prevails in categorizing the entire gross amount of the income generated by the U.S. assets as foreign source. This artificially inflates the taxpayer's foreign source income and allows the taxpayer to use foreign tax credits to reduce taxes on foreign source income beyond the maximum amount of U.S. tax that could be imposed on such income. This unintended tax planning technique has nothing to do with relieving double taxation.

S.A. 4575 respects the treaty commitment to treating such income as foreign source, but would segregate the income so that it is not the basis for claiming foreign tax credits that have nothing to do with double taxation. In doing so, the amendment conforms the foreign tax credit treatment of taxpayers operating abroad through foreign branches and disregarded entities to the treatment already afforded to taxpayers operating through foreign corporations. The provision would apply to taxable years beginning after the date of enactment.

Limitation on the use of section 956 for foreign tax credit planning (*i.e.*, the "hopscotch" rule)

U.S.-based multinational companies typically have complex foreign structures designed to mitigate their worldwide tax expense. In many cases, these structures include companies located in low-tax jurisdictions (*e.g.*, tax havens such as Bermuda and the Cayman Islands) in a multi-tier chain of subsidiaries. If a foreign subsidiary with a relative high tax expense distributes a dividend up through a chain of companies, the foreign tax credit on the dividend ultimately received by the U.S. shareholder is a blend of the tax rates of each foreign subsidiary in that chain. If there is a tax-haven company in that chain, the U.S. tax due on the dividend may be significantly higher than the tax would have been if the foreign subsidiary's dividend could have simply "hopscotched" over the chain as a direct distribution to the U.S. shareholder. Affirmative use of section 956, which was originally enacted as an anti-abuse provision, readily accomplishes this "hopscotch" by deeming a dividend from a foreign subsidiary directly to the U.S. shareholder. By taking advantage of this "hopscotch" rule, the foreign tax credit on this "deemed dividend" can be greater than the foreign tax credit would be on an actual dividend.

S.A. 4575 would limit the amount of foreign tax credits that may be claimed with respect to a deemed dividend under section 956 to the amount that would have been allowed with respect to an actual dividend. The provision would apply to the affirmative use of section 956 after December 31. 2010.

Special rule with respect to certain redemptions by foreign subsidiaries

Where a foreign-based multinational company owns a U.S. company, and that U.S. company owns a foreign subsidiary, the earnings of the foreign subsidiary are generally subject to U.S. tax when they are distributed to the U.S. shareholder. When those earnings are then distributed by the U.S. company to its foreign shareholder, a 30 percent withholding tax applies, unless reduced by treaty or some other provision of the tax code. Foreign-based multinational companies have devised a technique for avoiding U.S. taxation of such foreign subsidiary earnings. This technique involves a provision of the tax code that was originally enacted as an anti-abuse rule that treats certain sales of stock between related parties as a dividend. For example, under this provision, where a foreign-based multinational corporation sells stock in

the U.S. company to its foreign subsidiary, the cash received from the foreign subsidiary in this sale is treated as a dividend from that foreign subsidiary. This deemed dividend allows the foreign subsidiary's earnings to completely – and permanently – bypass the U.S. tax system.

S.A. 4575 would eliminate this type of tax planning by preventing the foreign subsidiary's earnings from being reduced and, as a result, the earnings would remain subject to U.S. tax (including withholding tax) when repatriated to the foreign parent corporation as a dividend. The provision would apply to acquisitions after date of enactment.

Modification of affiliation rules for purposes of rules allocating interest expense

To prevent double taxation (*i.e.*, full taxation by both a foreign country and by the United States on the same item of income), taxpayers are permitted to claim foreign tax credits with respect to foreign taxes paid on income earned offshore. To appropriately limit the use of the foreign tax credit system to the avoidance of double taxation, foreign tax credits are limited to the maximum amount of U.S. tax that could be imposed on the taxpayer's foreign source income (*i.e.*, 35 percent of the taxpayer's foreign source income). Taxpayers have used various techniques to minimize the amount of foreign source interest expense, which has the effect of artificially boosting foreign source income. In turn, this permits taxpayers to utilize more foreign tax credits than would otherwise be possible, and the use of such additional foreign tax credits has nothing to do with relieving double taxation. To prevent taxpayers from avoiding these rules, Treasury regulations prevent taxpayers from excluding foreign interest expense from the foreign tax credit limitation by placing it in foreign subsidiaries. The regulations achieve this result by including certain subsidiaries in the U.S. affiliated group. As a result, foreign source interest expense will be taken into account in the determination of the foreign tax credit limitation.

S.A. 4575 would modify the affiliation rules to strengthen these anti-abuse rules. The provision would apply to taxable years beginning after the date of enactment.

Repeal of 80/20 rules

Under current law, dividends and interest paid by a domestic corporation are generally considered U.S.-source income to the recipient and are generally subject to gross basis withholding if paid to a foreign person. If at least 80 percent of a corporation's gross income during a three-year period is foreign source income and is attributable to the active conduct of a foreign trade or business (a so-called "80/20 company"), dividends and interest paid by the corporation will generally not be subject to the gross basis withholding rules. Furthermore, interest received from an 80/20 company can increase the foreign source income of, and therefore the amount of foreign tax credits that may be claimed by, a U.S. multinational company. Treasury has become aware that some companies have abused the 80/20 company rules. As a result, the President's FY 2011 Budget proposes to repeal these rules.

S.A. 4575 would adopt the President's Budget proposal to repeal the 80/20 company rules. The amendment would also repeal the 80/20 rules for interest paid by resident alien individuals. The amendment would include relief for existing 80/20 companies that meet specific requirements and are not abusing the 80/20 company rules. Subject to the relief for these existing 80/20 companies, the provision would apply to taxable years beginning after December 31, 2010.

Technical correction to statute of limitations provision in the *HIRE Act*

S.A. 4575 would make a technical correction to the foreign compliance provisions of the *Hiring Incentives to Restore Employment (HIRE) Act* (**P.L. 111-147**) to clarify the circumstances under which the statute of limitations will be tolled for corporations that fail to provide certain information on cross-border transactions or foreign assets. Under the technical correction, the statute of limitations period will not be tolled if the failure to provide such information is shown to be due to reasonable cause and not willful neglect.

Other Revenue Offsets

Elimination of Advanced EITC

Presently, low- and moderate-income individuals may qualify for a refundable earned income tax credit (EITC). Individuals have the option of requesting advanced payments of the EITC throughout the year by having their payments of withheld income reduced by their employer. The advanced EITC payment option, however, is not popular and only about three percent of eligible EITC recipients choose this option.

S.A. 4575 eliminates the advanced EITC payment option.

Legislative History

On March 19, 2009, the House passed **H.R. 1586** by a vote of 328 – 93 (Roll number 143). On March 22, 2010, the Senate passed **H.R. 1586** with an amendment and an amendment to the title by a vote of 93 – 0 (Record vote number 61). On March 25, 2010, the House agreed with an amendment to the Senate amendments by a vote of 276 – 145 (Roll number 190). On August 2, 2010, Majority Leader **Reid** made a motion to concur in the House amendment to the Senate amendment, with an amendment, **Senate Amendment 4575** (described above), and filed a cloture motion on that motion. The education jobs funding provision included in **S.A. 4575** is similar to legislation introduced by Senator **Harkin** (**S. 3206**) with 29 cosponsors.

The Senate is expected to consider this amendment the week of August 2, 2010.

Expected Amendments

The DPC will distribute information on amendments as it becomes available to staff listservs.

Administration Position

On August 3, 2010, the White House released a Statement of Administrative Policy on **S.A. 4575** to **H.R. 1586**:

> "The Administration strongly supports Senate passage of Amendment 4575 to H.R. 1586, which would provide much-needed relief to teachers and critical assistance to hard-pressed States. Since teachers are essential to the quality of education that the Nation affords its children and to America's long-term strength and security, the Administration strongly supports the $10 billion Education Jobs Fund to avert the layoff of hundreds of thousands of

public school teachers as students return to school in the coming months. The Administration strongly supports the extension of the temporary increase in the Federal Medical Assistance Percentage (FMAP) for six months through June 2011, which will provide critical assistance to States to help them maintain their Medicaid programs during a period of high enrollment growth and reduced State revenue. In addition, to provide this assistance in a fiscally responsible way, the amendment includes revenue-raising provisions similar to those included in the President's Budget, including proposals to close international tax loopholes that currently allow multinational corporations to inappropriately lower their U.S. taxes."

Resources

Congressional Budget Office, "Budgetary Effects of Senate Amendment 4575, containing proposals related to education, state fiscal relief, the Supplemental Nutrition Assistance Program, rescissions, and revenue offsets," available here.

Congressional Research Service, "Education Jobs Fund Proposals in the 111th Congress," available here.

Congressional Research Service, "Medicaid: the Federal Medical Assistance Percentage," available here.

Congressional Research Service, "American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5): Title V, Medicaid Provisions," available here.