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Regulations: Foreign tax credits, and section 901(m) "covered asset acquisitions"

The U.S. Treasury Department and IRS today released for publication in the Federal Register long awaited guidance under section 901(m).

The guidance takes the form of comprehensive proposed regulations (Reg-129128-14) interpreting the statutory rules, and temporary regulations (T.D. 9800) that primarily incorporate guidance provided in prior IRS notices addressing dispositions of assets subject to section 901(m).

The proposed regulations would also modify the creditable foreign tax expenditure rules in Reg. section 1.704-1(b) so that foreign income taxes paid by a hybrid partnership are adjusted to take into account section 901(m).

Read text of the **temporary regulations** [PDF 322 KB] and the **proposed regulations** [PDF 666 KB]

Effective date provisions

The proposed and temporary regulations are scheduled to be published in the Federal Register on December 7, 2016.

The proposed regulations would generally apply to covered asset acquisitions (CAAs) occurring on or after the date final regulations are published in the Federal Register. Taxpayers may rely on the proposed regulations prior to finalization, but only if they consistently apply Prop. Reg. section 1.901(m)-2 (adding new categories of CAAs) to all CAAs occurring on or after the date of publication of the proposed regulations in the Federal Register, and consistently apply the rest of the proposed regulations to all CAAs occurring on or after January 1, 2011.

KPMG observation

Taxpayers will need to carefully weigh the benefits and detriments of early adoption of the proposed regulations.

Background

Section 901(m) was enacted in 2010 and generally limits a taxpayer's ability to claim foreign tax credits associated with a "covered asset acquisition" (CAA). In general, a CAA is an acquisition transaction that results in the creation of additional asset basis for U.S. tax purposes without a corresponding increase in asset basis for foreign tax purposes. The basis "step-up" resulting from a CAA may allow a taxpayer to claim additional depreciation or amortization deductions, thus reducing its earnings and profits for U.S. tax purposes.

Because there is no basis increase for foreign tax purposes, foreign taxable income—and thus foreign taxes—will generally be higher than if the U.S. basis step-up were taken into account in the foreign jurisdiction.

Although there is no official legislative history for section 901(m), a House Ways and Means Committee staff summary described the purpose of the CAA rules when section 901(m) was first proposed in May 2010 as part of the "American Jobs and Closing Tax Loopholes Act of 2010."[1] The summary explains that the general concern addressed by section 901(m) is that the increased cost recovery deductions available for U.S. tax purposes as a result of a CAA enable a taxpayer to generate additional foreign tax credits (FTCs) with respect to income that will never be recognized for U.S. tax purposes. Situations when income is recognized for foreign but no income is recognized for U.S. tax purposes are often referred to as "base differences."

[1] See House Ways and Means Committee summary of "The American Jobs and Closing Tax Loopholes Act of 2010," H.R. 4213, p. 21 (May 28, 2010), available at http://waysandmeans.house.gov/media/pdf/111/ America_Jobs_Summary.pdf (last visited Sept. 14, 2010). The summary was originally released on May 20, 2010, and updated on May 28, 2010. The only difference between the version of section 901(m) as enacted and the version included in H.R. 4213 is the effective date.

In 2014, the IRS and Treasury issued limited guidance on under section 901(m).

- Notice 2014-44 provided guidance relating to certain dispositions of assets following a section 901(m) covered asset acquisition (CAA). Specifically, the IRS notice defined a disposition to which section 901(m)(3)(B)(ii) applies, provided successor rules under which the unallocated basis difference in relevant foreign assets carries over to the new owner upon a disposition of such assets, and stated that future regulations would be issued reflecting this guidance. Read ***TaxNewsFlash-United States*** [PDF 77 KB]

- Notice 2014-45 was issued a week later, to clarify the effective date of the disposition rules. Read ***TaxNewsFlash-United States*** [PDF 74 KB]

Initial observations—proposed and temporary regulations

Perhaps unavoidably, the proposed and temporary regulations contain a very detailed and complex set of rules. For example, the computational aspects of the regulations provide different mechanics for transactions in which the U.S. and foreign tax systems take different views as to the entity liable for taxes attributable to the assets subject to 901(m) (i.e., hybrid and reverse hybrid situations). Taxpayers will need to pay careful attention to the many nuances of these rules when dealing with CAAs, whether in the context of planning or simply preparing tax returns.

The temporary regulations deliver on the government's promise issue the regulations described in Notice 2014-44 and Notice 2014-55, including the preservation of the effective dates contained in the IRS notices. In doing so, the regulations provide that subsequent transactions following a CAA (whether the subsequent transactions are taxable or non-taxable) will not allow taxpayers to purge basis differences that have not yet been recaptured. The temporary regulations also contain a provision explicitly excepting withholding taxes from the scope of 901(m) on the ground that such taxes are computed on gross amounts and therefore do not implicate the policy considerations underlying section 901(m). Read a discussion of the disposition rules in the IRS notices, incorporated in the temporary regulations, ***TaxNewsFlash-United States*** [PDF 77 KB] concerning Notice 2014-44 and ***TaxNewsFlash-United States*** [PDF 74 KB] concerning Notice 2014-45.

The proposed regulations are much more broad-reaching than the temporary regulations. They contain a multitude of definitional and computational provisions (there are 45 defined terms in Prop. Reg. section 1.901(m)-1 alone). In particular, three new classes of transaction are swept into the scope of section 901(m)—transactions treated as asset acquisitions for U.S. tax purposes and the acquisition of interests in a partnership or similar entity for foreign tax purposes partnership distributions giving rise to a basis increase under section 732(b) or 732(d) with no corresponding basis adjustment under foreign law, and transactions respected as asset transfers for the U.S. and foreign law purposes but giving rise to a basis increase under U.S. law without any corresponding increase for foreign purposes (e.g., a "busted" 351 transaction). The computational aspects of the regulations go into great detail in providing different mechanics for transactions in which the U.S. and foreign tax systems take different views as to the entity liable for taxes attributable to the assets subject to 901(m) (i.e., hybrid and reverse hybrid situations).

Overall, the regulations appear to fairly implement the intent of Congress in enacting section 901(m). There is also some good news in terms of simplification / relaxation of the statutory rules. For example, in computing disallowed taxes, the entire foreign income and foreign tax liability of a foreign taxpayer is used—rather than attempting to trace income and taxes to specific assets. In addition, a de minimis rule is provided, although its scope is very limited except as relates to CAAs between unrelated parties. Also, an election is provided to measure the basis difference by comparing

U.S. and foreign tax bases rather than comparing U.S. tax basis before and after a CAA.

However, the modest notes of simplification from these provisions are outweighed by the overall complexity of the package. To be fair, this is understandable given the wide range of fact patterns that can result in the phenomenon which Congress sought to curtail (the United States granting foreign tax credits in respect of amounts not included in the U.S. tax base by virtue of a basis step-up for U.S., but not foreign, tax purposes). However, the result is a set of rules that may be quite difficult for taxpayers and their advisors to apply. The proposed regulations also include four separate anti-abuse rules that can come into play if a taxpayer acts with a bad principal purpose.

Read **KPMG's outline** [PDF 64 KB] of the proposed and temporary regulations.

For more information, contact one of the following tax professionals or any member of KPMG's Washington National Tax International Tax practice:

Seth Green | +1 (202) 533-3022 | sethgreen@kpmg.com

Caren Shein | +1 (202) 533-4210 | cshein@kpmg.com

Bob Wilkerson | +1 (404) 222-3639 | rwilkerson@kpmg.com

Barbara Rasch | +1 (202) 533-8181 | brasch@kpmg.com