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Now Final §901(m) Regulations Relax Few of the Rules from the Proposed Regulations

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INTRODUCTION

Section 901(m) was a 2010 revenue raiser and an anti-abuse provision from a different era in U.S. international tax.[1] Section 901(m) arose in the world of deferral and post-1986 E&P and tax pools, where taxpayers could selectively repatriate high-taxed earnings and defer low-taxed earnings from tax, and when the United States had one of the highest statutory rates of corporate tax in the world. Through this provision, Congress sought to cut back the foreign tax credit benefit from §338 elections and similar transactions that produced amortization for U.S. E&P purposes, but not for local tax purposes — so-called ''covered asset acquisitions.'' Such transactions might be the product of planning or, more commonly, the result of taxpayers' natural choice to elect §338(g) in the acquisition of a foreign target, particularly where the foreign target and the sellers of stock were foreign persons not affected in any way by the buyer's §338 election.

In December 2016, the IRS and Treasury issued proposed regulations[3] providing detailed guidance on §901(m) and the calculations of the amount of disqualified taxes.[4] Some of these calculations are painfully detailed, for example, the rules for dispositions or third country creditable taxes. The Proposed Regulations generally were prospective only, so that perhaps some tax professionals left the Proposed Regulations on the shelf. Now, virtually all of the rules found in the Proposed Regulations have been included in the Final Regulations and are generally effective for covered asset acquisitions completed after March 23, 2020.[5] This article serves to reacquaint readers with the now final regulations and highlight some of the key provisions that were retained from the Proposed Regulations.

COVERED ASSET ACQUISITIONS CATEGORIES — THE REGULATIONS GREATLY EXPAND THE REACH OF §901(m)

The Proposed Regulations greatly expanded the scope of ''covered asset acquisitions'' (''CAAs'') to which §901(m) applies. As will be seen, the Final

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[1] All section references herein are to the Internal Revenue Code, as amended (the ''Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[3] NPRM REG-129128-14 (Dec. 7, 2016) (hereinafter, the ''Proposed Regulations''). The final regulations were issued T.D. 9895 (Mar. 23, 2020) and are referred to here as the Final Regulations.

[4] In a previous article in this journal, the author covered the §901(m) Proposed Regulations: *Unpacking the New §901(m) Proposed Regulations*, 46 Tax Mgmt. Int'l J. 303 (June 9, 2017). This article focuses only on the portions of the Proposed Regulations that were changed or subject of significant commentary in the rulemaking process.

[5] *See, e.g.*, Reg. §1.901(m)-1(b)(1).

Regulations retained the broad catch-all category of any asset transfer that has different basis consequences for U.S. and foreign purposes, despite commentary asking for this rule to be limited or removed. Going forward, it is safe to assume that any movement of assets giving rise to a ''basis difference'' will be subject to §901(m). More transactions, particularly internal restructurings, will need to be monitored for potential §901(m) issues.[6]

The statute applies to three specified transactions that typically have been used to give rise to the benefit that §901(m) was enacted to prevent: a stock purchase with a §338(g) election, a stock purchase treated as an asset purchase because the target has elected disregarded entity status (e.g., a ''check-and-sell'' transaction), and a purchase of an interest in a partnership with a §754 election.[7] One common feature of the statutory categories of ''covered asset acquisitions'' is that they all involve a U.S. tax election that results in effectively a hybrid treatment. Under the Final Regulations, §901(m) no longer is so limited.

Specifically, in addition to categories for transfers of interests in pass-through entities, the Final Regulations treat as a covered asset acquisition ''any transaction. . .to the extent it is treated as an acquisition of assets for purposes of both U.S. income tax and a foreign income tax, provided that the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one of more assets.''[8] Thus, §901(m) will not apply to pure asset transfers that receive a different U.S. and foreign tax treatment. For example, the regulations include an example of a §351 transaction where CFC1 transfers assets to CFC2 in return for stock and boot.[9] For U.S. tax purposes, CFC2 receives a stepped-up basis in the assets to the extent of CFC1's gain recognition under §351(b). To the extent CFC2 does not receive a corresponding foreign tax basis step-up, §901(m) will now apply to CFC2.

While the Example in the regulations could be the result of planning by the taxpayer, such as through the issuance of ''non-qualified preferred stock,'' such planning will come with a cost under the Tax Cuts and Jobs Act of 2017 (''TCJA'') (Pub. L. No. 115-97) given that CFC1's gain would be taxed as subpart F income or global intangible low-taxed income (GILTI). In addition, the rule does not require any planning to be done; it is activated whenever a transfer of assets results in a higher basis for U.S. than for foreign purposes. As a result, internal restructurings now will be rife with potential §901(m) implications.

This raises the stakes in ensuring that an internal transaction is tax-free in that busting tax-free treatment will result not only in the recognition of gain, but also loss of the tax benefit of the corresponding step-up. For example, assume that in the example above, CFC2 did not pay cash boot to CFC1, but the transfer inadvertently resulted in taxable gain, due to the failure to satisfy the ''control'' requirement, the presence of a ''springing'' note, or liabilities in excess of basis under §357(c). Such gain will be included in U.S. Parent's income as tested income or subpart F income. Not only that, but the taxpayer now is subject to loss of part of its foreign tax credits under §901(m).[10]

The same problem seemingly could also arise where a U.S. person makes a taxable outbound transfer of assets to a controlled foreign corporation under §367. Assume U.S. taxpayer incorporates a foreign branch. Under the more rigorous §367 rules after the TCJA, outbound transfers will normally be taxable under §367(a) and/or §367(d).[11] A gain under §367(a) would normally increase the basis of the CFC's assets without a corresponding increase to foreign tax basis. Again, the taxpayer would appear to face the unpleasant combination of recognizing fully taxable gain, without enjoying the benefits of the basis step-up.

Comments requested relief in the situation where the same U.S. taxpayer is effectively on both sides of the covered asset acquisition, so that the taxpayer would recognize gain for U.S. tax purposes on the sale of the relevant foreign assets (RFAs). With GILTI, subpart F, and §965, the gain on the sale would almost always be included in the same taxpayer's income.[12] In other words, if the same or a related taxpayer ''paid for'' the basis step-up, from a policy

[6] This monitoring will be particularly important for anyone contemplating the early adoption of the final regulations, for example, to obtain the benefit of the Foreign Basis Election, discussed below. As discussed below, early adoption of the regulations will cause the broadened set of CAAs to apply to any transactions done after the December 2016 issuance of the Proposed Regulations. *See* Reg. §1.901(m)-2(f)(3)(i).

[7] *See* §901(m)(2).

[8] Reg. §1.901(m)-2(b)(6).

[9] Reg. §1.901(m)-2(e)(2) *Ex.* 2.

[10] The IRS declined to provide relief for situations where the CAA itself is subject to U.S. tax by the taxpayer, because of the ''possibility of manipulation of foreign tax credits.'' T.D. 9895, Preamble §1. However, in the new worldwide system created by GILTI, such possibilities are limited and remote.

[11] *See* §367(d)(4) (broadened definition of intangibles) and TCJA §14102(e)(1) (repealing the active business exception of former §367(a)(3)). Query whether there is a difference in this regard between gain recognized under §367(a) and deemed royalties under §367(d).

[12] For transactions in the ''disqualified period'' between December 31, 2017 and the first effective date of GILTI, other well-known sets of regulations under §245A and §951A prevent the taxpayer from reaping a benefit from a ''costless'' sale.

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perspective, the transaction should be exempt from §901(m)'s disallowance of foreign tax credits.

In response to these comments, the Final Regulations crafted very limited relief where both the buyer and seller of the assets are the same person or members of the same U.S. consolidated group.[13] For example, if one member of a consolidated group sold a foreign branch to another member of the same consolidated group, the buying member would not be subject to §901(m) to the extent of the selling member's recognition of gain. However, transfers of assets in foreign-to-foreign, U.S.-to-foreign, or foreign-to-U.S. transactions involving CFCs of the U.S. taxpayer would seem not to enjoy any such relief, notwithstanding that the gain is taxed as subpart F income or GILTI.[14]

RELEVANT FOREIGN ASSETS AND THE ONE-YEAR RULE

Another important issue addressed by the Final Regulations is the foreign country whose taxes are affected by §901(m). Generally, the disallowance of credits applies to the country under whose laws the basis in the assets is relevant immediately after the covered asset acquisition.[15] Thus, for example, if CFC1 is acquired with a §338(g) election, §901(m) will disallow taxes in CFC1's country of residence. If CFC1 holds the assets through a foreign branch on the date of the acquisition, the branch jurisdiction's taxes will also be affected by §901(m).

The Final Regulations retain an important provision from the Proposed Regulations that is reminiscent of the ''imported hybrid mismatch'' rules in BEPS and §267A. Specifically, if the assets, within the one-year period after the acquisition, become relevant in another jurisdiction, the §901(m) taint also applies in that second jurisdiction.[16] This rule purports to be an anti-abuse rule; however, as has been become familiar in recent rulemaking, an abusive purpose will be deemed to exist if the assets become relevant within one year of the acquisition.

This rule will need to be considered in any post-acquisition restructuring. For example, assume that U.S. Parent acquires Foreign Target, which is organized in a tax haven, with a §338(g) election. Shortly after the acquisition, U.S. causes the newly acquired Foreign Target, now a CFC, to contribute or sell its intellectual property to a CFC organized in Ireland. Section 901(m) would now seem to apply to the Irish taxes imposed on the Irish CFC that holds the relevant foreign assets, unless the re-transfer of the assets created a corresponding step-up in basis for Irish tax purposes that eliminated the basis difference.[17] According to the example in the regulations, the same rule may even apply to an *entirely domestic §338(h)(10) transaction*, where the U.S. target's assets contributed to a foreign entity within one year after the acquisition![18]

MEASURING THE AGGREGATE BASIS DIFFERENCE — THE FOREIGN BASIS ELECTION SURVIVES, BUT EARLY ADOPTION COMES WITH COSTS

Once a covered asset acquisition has occurred, the ''aggregate basis difference'' will largely determine how much of the payor's foreign tax credits are disallowed. The disallowance formula, discussed in further detail below, disallows a portion of the credits of the taxpayer using a fraction equal to the allocated ''aggregate basis difference'' over the taxpayer's foreign income for the year. Under the statute, however, the aggregate basis difference technically is not measured using the difference between U.S. and foreign tax basis; rather the measurement point is the difference be-

[13] The relief is found in the definition of ''aggregate basis difference'' and ''allocated basis difference.'' *See* Reg. §1.901(m)-1(a)(1), §1.901(m)-1(a)(6). Aggregate basis difference results in a disqualified tax amount. It consists of ''allocated basis differences,'' which is now defined to exclude basis differences where the allocated CAA gain (another defined term), has been recognized by the §901(m) payor or a member of its consolidated group. The §901(m) payor is the entity, CFC or U.S., that is the technical taxpayer for relevant foreign taxes. In the case of a CFC that acquires the relevant foreign assets, the CFC, not the U.S. taxpayer, is the ''§901(m) payor.'' *See* Reg. §1.901(m)-3(b)(3) *Ex.* 1.

[14] Such a narrow approach is justified in the Preamble by a reference to foreign tax credit ''manipulation,'' with the only example of ''manipulation'' being the case where the entity recognizing the gain is exempt from tax under §501. Cases where U.S. taxpayers with foreign operations have an exempt organization in their consolidated group would appear to be very rare indeed.

[15] *See* Reg. §1.901(m)-2(c)(2).

[16] Reg. §1.901(m)-2(c)(3).

[17] It is not accidental that the one example in the Regulations of this rule is a §351 transfer of assets by the initial acquiring entity to an affiliate. *See* Reg. §1.901(m)-2(e)(3) *Ex.* 3. If the transfer of assets constitutes a disposition that is taxable for foreign income tax purposes, then the basis difference associated with the first CAA would seem to be eliminated causing this rule to be moot. Thus, this subsequent transfer rule is most likely to apply where the RFAs are transferred out of a country in a transaction that is not taxable in the first foreign jurisdiction. Would a license of the relevant IP assets by CFC1 to CFC2 for royalties result in any application of §901(m) to CFC2?

[18] *See* Reg. §1.901(m)-2(e)(3) *Ex.* 3. Such a transaction, of course, could be subject to §367(a) and/or §367(d). Application of §367(a) or §367(d) would not create the corresponding increase in basis of assets necessary to eliminate the §901(m) problem.

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tween *U.S.* basis *before* and *U.S.* basis *after* the acquisition. Congress presumably intended to capture the difference between U.S. and foreign tax basis created by the covered asset acquisition.

The Final Regulations retain the favorable ''foreign basis election'' introduced under the Proposed Regulations. Under the foreign basis election, in lieu of measuring the step-up in the *U.S. tax basis* of assets from the acquisition, the taxpayer compares *U.S. tax basis after* the acquisition with *foreign tax basis after* the acquisition.[19] Foreign tax basis after the acquisition specifically takes into account any foreign tax law step-up (e.g., ''basis bump'' or amortizable local goodwill) resulting from the acquisition itself.[20]

The foreign basis election will be helpful to taxpayers in a couple of ways. First, as an administrative matter, it will usually be easier to compare U.S. tax basis to foreign tax basis, rather than examine the hypothetical U.S. tax basis of assets in an entity that may never have been a U.S. taxpayer or relevant for U.S. purposes.[21] Second, taking into account a foreign basis step-up in the transaction may be critical for a taxpayer that uses foreign law to obtain a local tax amortization deduction for goodwill, etc. Under the statutory formula, the foreign step-up would not affect the basis difference and §901(m) disallowance fraction. Application of §901(m) in this context is an unfair penalty on the taxpayer.

For example, assume that the U.S. taxpayer acquired a Canadian target for $100 million and made a §338(g) election to step up the U.S. tax basis in its assets from $40 million to $100 million. Assume Target also was allowed to increase its tax basis for Canadian purposes by the same amount and receives, for simplicity of illustration, additional Canadian tax deductions of $4 million per year, that match the additional §197 amortization. After the acquisition, Target generates $10 million of profit before tax and, after §197 amortization, has $6 million of tested income. From a foreign tax perspective, Target also has $6 million of taxable income and pays $1.5 million of tax. In this case, without the foreign basis election, §901(m) would seem to reach an overly harsh result of disallowing ⅔ of foreign target's taxes as a credit ($4 mm ABD/$6 mm foreign income), despite the fact that there is no U.S. and foreign tax basis difference after the sale. The result in this case is simply the product of the statutory formula not fitting the facts. The Final Regulations sensibly allow taxpayers, through a properly filed foreign basis election, to correct this result.

The foreign basis election is made by the taxpayer's use of foreign basis on its tax return as filed to compute the basis difference.[22] No specific form is required to be filed to make the election. Except for transition relief noted below, the election must be made on a timely filed return for the year of the CAA and no §9100 relief is permitted. The election also is irrevocable.[23]

The Final Regulations allow taxpayers to retroactively apply the foreign basis election to the enactment of §901(m). This could ease compliance with §901(m) computations required to re-compute U.S. tax basis, or allow taxpayers obtaining a foreign tax law step-up to avoid punitive results. Taxpayers have one year to evaluate whether or not to early adopt the foreign basis election by filing amended returns on or before March 23, 2021.[24]

Making the foreign basis election early, however, also requires the taxpayers to roll back all of the Proposed Regulations retroactively, by amending all tax returns for all open taxable years. Taxpayers must make appropriate adjustments in open years to account for deficiencies that would have arisen in closed taxable years.[25] For many taxpayers this would seem to be a tall if not impossible task, given the intervening application of §965. In addition, early adoption requires taxpayers to apply the broadened definition of covered asset acquisitions to all transactions after December 2016. This could be a major downside to early application of the rules.

SECTION 901(m) CALCULATIONS — THE DISQUALIFIED TAX AMOUNT AND ABD CARRYOVER

Once a CAA has occurred and the basis difference been determined, the taxpayer must apply a formula to determine the fraction of foreign income taxes that are disqualified as a credit. The Final Regulations, like the Proposed Regulations, set forth a detailed set of computational rules. Since the final rules have not changed much, they will not be rehashed here.

One notable aspect of the Proposed Regulations that was carried through into the Final Regulations was the concept of an ''ABD carryover amount''

[19] Reg. §1.901(m)-4(c)(1).

[20] *Id.* (last sentence).

[21] In some cases, there will be opportunities to minimize the basis difference by studying the target's U.S. tax history, for example, to identify prior transactions that may have increased the target's U.S. tax basis. *See* Fuller & Halpern, *Some Further Thoughts on Covered Asset Acquisitions: Can the IRS Save Us (and Itself) from Code Sec. 901(m)?,* CCH Int'l Tax J., June 2011. However, it is helpful that taxpayers are allowed the convenience of electing to calculate the formula using U.S. tax basis.

[22] Reg. §1.901(m)-4(c)(4).

[23] Reg. §1.901(m)-4(c)(7).

[24] Reg. §1.901(m)-4(c)(6).

[25] Reg. §1.901(m)-4(g)(3)(iii).

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which is a running tally of basis differences that are recovered as U.S. tax deductions without resulting in a disallowance of foreign tax credits under §901(m). Under the Code, foreign taxes are disallowed on an annual basis. Section 901(m) sets out a formula that, for each year, simply multiplies the foreign taxes for the year by a fraction equal to (A) basis difference allocated to the year/(B) foreign income for the year.[26] If the basis difference is recovered in a year in which there are no relevant foreign taxes or no foreign income, the statute would favor the taxpayer by allowing the basis difference to be reduced without a corresponding disallowance of credits.

The Preamble to the Final Regulations expresses concern that this simple statutory formula could facilitate planning with timing differences. For example, the Preamble describes a case of a CFC that is on a March 31 fiscal year for foreign purposes, but December 31 year-end for U.S. purposes, and then sells the relevant foreign asset between March 31 and December 31 of Year 1.[27] Due to the accrual rules under the all-events test, the foreign income tax is taken into account in U.S. Year 2, the year in which or with which the foreign tax year ends. In this case, the basis difference is recovered in Year 1, and does not match the imposition of foreign tax.

To curb this and similar planning, the rules could have provided a special rule for dispositions of this type. However, the Final Regulations retain a broader ''ABD carryover'' rule for this situation. Under Reg. §1.901(m)-5(c), the basis difference from the Year 1 disposition becomes an ABD carryover amount that is taken into account under the §901(m) fraction in subsequent years unless and until the full and appropriate amount of foreign taxes have been disallowed.

Specifically, the Final Regulations, like the Proposed Regulations, define the ABD carryover amount as equal to the entire ABD recovered in a year, if there is no disqualified tax amount. If there is a disqualified tax amount, but the ABD exceeds foreign income, then the excess of the ABD over the foreign income will carry over to the following year.[28] In either case, the ABD carryover amount may be difficult or impossible to cleanse and will cause a compounding disallowance of taxes under §901(m).

Due to its broad reach, the ABD carryover rules may apply in garden variety situations. For example, if the foreign target has a net operating loss (NOL) for local tax purposes, its foreign income and disqualified tax amount will be zero, causing the taxpayer to have an ABD carryover amount. As additional cost recovery deductions arise year over year, the ABD carryover will grow, so that when the local entity eventually begins to pay foreign tax, its §901(m) disallowance will be exacerbated. Taxpayers not tracking the ABD carryover may be surprised by the loss of foreign tax credits that results.

SUCCESSOR RULES AND DISPOSITIONS

The Final Regulations retain the successor and disposition rules of the Proposed Regulations without any substantive changes.

In a scenario where the relevant foreign assets are disposed of, §901(m) generally causes the entire basis difference to be recovered with a resulting full disallowance of any foreign taxes on the disposition. For example, assume that U.S. Parent acquires a foreign target with a §338(g) election, checks the box, and causes Foreign Target to sell its IP for $70 million to U.S. Parent. The IP sale, although not taxable in the United States, would result in a basis difference being recovered equal to the lesser of the foreign gain or total basis difference in the assets.[29] Most or all of the foreign taxes on the sale to U.S. Parent may be disallowed.

In addition to taxable dispositions, the Final Regulations include successor rules for non-taxable restructurings and asset transfers. These rules need to be considered in any movement of relevant foreign assets after the acquisition, together with the one-year ''anti-abuse rule'' that cause the §901(m) taint to cross borders. Reg. §1.901(m)-6(b) provides that any remaining basis difference in a relevant foreign asset carries over to the transferee in any transfer of the assets (unless such transfer is a disposition that accelerates the basis difference). For example, if a CFC checks or unchecks the box on a foreign target, this check-the-box election will not accelerate the §901(m) event because no foreign tax is imposed. Rather the CFC or foreign branch that is deemed to inherit the assets will also inherit the §901(m).[30] An ABD carryover amount may also follow the relevant foreign assets in certain non-taxable asset transfers.[31]

Under the foregoing successor rules, there may be no escape from §901(m) other than bringing the assets entirely back to the United States.

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[26] *See* §901(m)(3)(A).

[27] *See* T.D. 9895, §2.

[28] *See* Reg. §1.901(m)-3(c)(2). As under the Proposed Regulations, an ABD carryover may also arise to the extent that the ''tentative'' disallowed taxes exceed the actual disallowed taxes, for example, because of third-country taxes that are available as foreign tax credit. *See* Reg. §1.901(m)-3(c)(2)(ii)(B).

[29] *See* Reg. §1.901(m)-5(c)(2)(ii)(A).

[30] *See* Reg. §1.901(m)-6(b)(5) *Ex.*

[31] *See* Reg. §1.90(m)-6(c).

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DE MINIMIS RULES — STILL ONLY A MINOR HELP

The Final Regulations retain the de minimis rules from the Proposed Regulations with limited modifications. In the Proposed Regulations, there were two separate *de minimis* rules, (1) an overall *de minimis* rule and (2) a class-based *de minimis* rule based on assets acquired within one or more §1060 asset classes. Generally, the thresholds of the two exceptions remain unchanged; the overall de minimis rule applies only if the total basis difference does not exceed the *greater of* (a) $10 million or (b) 10% of the U.S. tax basis after the acquisition. The *asset-class based exemption* applies if the basis difference for the relevant foreign assets in one of the seven asset classes under the §1060 rules[32] does not exceed the *greater of* (a) $2 million or (b) 10% of the U.S. tax basis in that class of assets after the acquisition. As under the Proposed Regulations, the Final Regulations apply the exceptions by aggregating all related acquisitions that are part of a plan.[33]

The Final Regulations liberalize the de minimis rules in two minor respects. First, a relevant foreign assets exception is available if the basis difference in any individual relevant foreign asset is less than $20,000. Second, the tighter thresholds for covered asset acquisitions involving related parties have been removed. In light of current taxation of such transactions under subpart F or GILTI, perhaps the lack of any de minimis rule for related-party transactions was no longer necessary.

CONCLUSION

Following tax reform, and movement to the global tax system under GILTI, §901(m) remains as relevant as ever. With U.S. companies' inclusion of most of their CFCs' foreign income as GILTI or subpart F income on a current basis, the additional amortization provided by a §338(g) will continue to be valuable and in some cases, will be more immediately relevant to taxpayers than it was prior to tax reform. Thus, the recently issued Final Regulations under §901(m) will come into play in foreign acquisitions as U.S. taxpayers continue to make §338(g) elections. Although some taxpayers may forgo §338(g) elections, the ability to amortize the purchase price for GILTI purposes is valuable, even with the §901(m) disallowance of part of the foreign tax credits. Thus, beginning as of March, external mergers and acquisitions, as well as internal transactions resulting in basis differences, will be subject to these very detailed rules of the Final Regulations.

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[32] *See* generally Reg. §1.338-6(b).

[33] *See* Reg. §1.901(m)-7(c).

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