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Notice 2014-44 - Foreign tax credits and section 901(m) covered asset acquisitions

July 21: The IRS today released an advance copy of Notice 2014-44 which provides guidance relating to certain dispositions of assets following a section 901(m) covered asset acquisition (CAA).

Specifically, Notice 2014-44 provides a definition of a disposition to which section 901(m)(3)(B)(ii) applies, and provides successor rules under which the basis difference in relevant foreign assets carries over to the new owner.

Notice 2014-44 [PDF 49 KB] states that Treasury and the IRS will issue future regulations reflecting this guidance.

Background

Section 901(m), enacted in 2010, limits a taxpayer's ability to claim foreign tax credits related to a "covered asset acquisition" (CAA). In general, a CAA is an asset acquisition 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.

Section 901(m)(2) lists three specific categories of transactions that constitute CAAs: (1) a qualified stock purchase under section 338; (2) an acquisition of an interest in a partnership for which a section 754 election is in effect; and (3) any transaction treated as an asset acquisition under U.S. tax law and a stock acquisition or disregarded transaction under foreign law (e.g., a sale of a DRE).

In addition, section 901(m)(2) provides regulatory authority to expand the scope of the rules to cover "any similar transaction." Today's notice does not exercise that regulatory authority.

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. Section 901(m) aims to disallow foreign tax credits for foreign taxes imposed on the income not recognized for U.S. tax purposes.

Specifically, section 901(m)(1) denies a foreign tax credit for the "disqualified portion" of any foreign income tax determined with respect to the income or gain attributable to the "relevant foreign assets." The disqualified portion of taxes for a taxable year is the ratio of: (1) the aggregate "basis differences" (but not below zero) allocable to that year with respect to all relevant foreign assets (RFA); over (2) the income on which the related foreign income tax is determined.

For this purpose, section 901(m)(3)(C) defines "basis difference" for each RFA as the excess of: (1) the adjusted tax basis of that asset for U.S. federal income tax purposes immediately after the CAA; over (2) the adjusted tax basis of that asset for U.S. federal income tax purposes immediately before the CAA. The basis difference for each asset then is allocated over all tax years constituting the useful life of the asset under U.S. cost recovery rules.

If there is a "disposition" of an asset before the end of the cost recovery period, section 901(m)(3)(B)(ii) allocates the remaining portion of that asset's basis (the unallocated basis difference) entirely to the year of the disposition.

The statute does not limit transactions that are to be treated as "dispositions" under this rule. The Joint Committee on Taxation's technical explanation of section 901(m), however, states that Congress intended:

> . . . that this provision generally apply in circumstances in which there is a disposition of a relevant foreign asset and the associated income or gain is taken into account for purposes of determining foreign income tax in the relevant jurisdiction.

Notice 2014-44

Notice 2014-44 implements this intent by limiting transactions treated as dispositions under section 901(m) and by providing that any unallocated basis difference not recognized as a result of a disposition of relevant foreign assets carries over to the new owner and continues to potentially limit allowable foreign tax credits until fully taken into account.

Transactions that IRS concluded are not subject to the disposition rule

The IRS and Treasury stated that they are aware that certain taxpayers are engaging in transactions shortly after a CAA occurs that are intended to invoke application of the statutory disposition rule under section 901(m)(3)(B)(ii) to avoid the purpose of section 901(m).

Notice 2014-44 provides the following example.

> Assume USP, a domestic corporation, wholly owns FSub, a foreign corporation, and FSub acquires 100% of the stock of FT, a foreign corporation, in a qualified stock purchase (as defined in section 338(d)(3)) for which an election under section 338(g) is made. The acquisition of the stock of FT is a section 338 CAA, and the assets of FT are RFAs with respect to that section 338 CAA. Shortly after the acquisition of FT in the section 338 CAA, FT becomes disregarded as an entity separate from its owner pursuant to an entity classification election under Reg. section 301.7701-3. As a result of the entity classification election, FT is deemed, solely for U.S. tax purposes, to distribute all of its assets and liabilities to FSub in liquidation (deemed liquidation) immediately before the closing of the day before the election is effective. On these facts, no gain or loss is recognized on the deemed liquidation by either FT or FSub pursuant to sections 332 and 337.

According to the IRS notice, taxpayers take the position that the deemed liquidation constitutes a disposition of the RFAs for purposes of section 901(m)(3)(B)(ii). As a result, taxpayers claim that all of the basis difference with respect to the RFAs is allocated to the final tax year of FT that occurs by reason of the deemed liquidation, and that no basis difference with respect to the RFAs is allocated to any later tax year.

The IRS and Treasury believe this result to be inappropriate because: (1) the basis disparity in the assets for U.S. and foreign purposes arising from the section 338 election continues to exist after the deemed liquidation; and (2) because no gain is recognized for foreign income tax purposes as a result of the deemed liquidation, there is also no foreign income tax that is subject to disqualification under section 901(m) as a result of the liquidation.

Rules to be included in future regulations

To address this situation, the IRS and Treasury intend to issue regulations incorporating the following rules provided in Notice 2014-44.

Notice 2014-44 first limits the definition of a disposition for section 901(m) purposes to include only events that result in gain or loss recognition with respect to an RFA **for purposes of U.S. income tax, foreign income tax, or both.** Under this definition, the tax-free deemed liquidation of FT in the above example is not a disposition because no gain or loss is recognized under either U.S. or foreign tax law.

Notice 2014-44 then provides a new definition of the "disposition amount." The disposition amount is the portion of the basis difference in a RFA that is taken into account in the year of the disposition.

If a disposition is fully taxable for both U.S. and foreign purpose, the "disposition amount" is the full unallocated basis difference. If a disposition is only partly taxable for either U.S. or foreign purposes (e.g., a section 351 with "boot"), there would continue to be a basis disparity and the unallocated basis difference is taken into account only to the extent the basis disparity for U.S. and foreign tax purposes is reduced. Notice 2014-44 provides two examples illustrating these rules.

Notice 2014-44 also provides special rules for RFAs in a section 743(a) CAA. The basis difference in the RFA generally is the resulting basis adjustment under section 743(b) that is allocated to the RFA under the rules of section 755.

Finally, Notice 2010-44 provides a successor rule under which section 901(m) will continue to apply to an RFA until the entire basis difference has been taken into account under the general rule in section 901(m)(3)(B)(i) using the applicable cost recovery method for U.S. tax purposes, or as a disposition amount (or both).

Notice 2014-44 reserves on whether and to what extent section 901(m) is to apply to an asset received in exchange for an RFA in a transaction in which the basis of the asset is determined by reference to the basis of the RFA transferred.

Effective date

In general, the future regulations will apply to dispositions occurring on or after July 21, 2014.

Parts of the regulations will apply to section 743(b) CAAs occurring on or after July 21, 2014, but taxpayers may consistently apply the guidance in those paragraphs to all section 743(b) CAAs occurring on or after January 1, 2011.

Other parts of the regulations will apply to any unallocated basis difference with respect to an RFA as of July 21, 2014, and any basis difference with respect to an RFA that arises in a CAA occurring on or after July 21, 2014.