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TaxNewsFlash

United States

Proposed and temporary regulations under section 901(m) issued December 6, 2016

A preliminary outline

Prop. Reg. § 1.901(m)-1 and Reg. § 1.901(m)-1T

Proposed Reg. § 1.901(m)-1 defines relevant terms. Most of the same definitions are simultaneously issued in temporary form in Reg. § 1.901(m)-1T. Approximately half of the definitions apply to CAAs occurring after the publication of final regulations, while the other half (definitions relevant to the temporary regulation rules on dispositions of relevant foreign assets ("RFAs") are effective for CAAs occurring after July 21, 2014, and to CAAs occurring before that date resulting from an entity classification election filed after July 29, 2014, and effective before July 21, 2014.

Prop. Reg. § 1.901(m)-2 and Reg. § 1.901(m)-2T

Proposed Reg. § 1.901(m)-2 and the corresponding temporary regulation describe transactions that constitute CAAs subject to section 901(m) and assets that are treated as RFAs in a CAA.

The temporary regulation (cross-referenced in the proposed regulation) describes the three categories of CAAs specifically listed in section 901(m)(2)(A)-(C):

- A qualified stock purchase to which section 338(a) applies,
- Any transaction treated as an asset acquisition for U.S. tax purposes and either a stock acquisition or a disregarded transaction for foreign tax purposes, and
- Any acquisition of an interest in a partnership that has an election in effect under section 754.

The statutorily defined transactions are CAA even if there is in fact no basis step-up for U.S. income tax purposes immediately after the transaction.

The proposed regulation, pursuant to the grant of regulatory authority in section 901(m)(2)(D) to address "similar transactions" adds three additional categories of transaction that would be treated as CAAs:

- Any transaction or series of transactions occurring pursuant to a plan to the extent treated as an asset acquisition for U.S. income tax purposes and as an acquisition of an interest in a fiscally transparent entity for foreign income tax purposes. This type of transaction, as with the statutorily defined CAAs, is assumed to create a basis step-up for U.S. tax purposes and would be treated as a CAA even if there is in fact no basis step-up at the time of the transaction.

Example: FC1 and FC2 own FPS, an entity treated as a partnership under U.S. and foreign law. FPS owns asset A. USP owns all of the interests in a disregarded entity (DE). Pursuant to a plan, USP then acquires FC1's interest in FPS and DE acquires FC2's interest. The transaction is a CAA because it is treated for U.S. income tax purposes as an acquisition of Asset A, while for foreign income tax purposes it is treated as an acquisition of a partnership interest. *(Prop. Reg. § 1.901(m)-2(e), Example 1).*

- Any transaction or series of transactions occurring pursuant to a plan to the extent treated as a partnership distribution of assets for which the U.S. tax basis is determined under section 732(b) or (d) or which causes a section 743(b) adjustment to the U.S. basis in the partnership's remaining assets, but only if the transaction results in a step up in the basis of any assets distributed or retained by the partnership for U.S. income tax purposes without a corresponding foreign basis increase.

- Any transaction or series of transactions occurring pursuant to a plan to the extent treated as an asset acquisition for both U.S. and foreign income tax purposes if the transaction results in a basis step up for U.S. but not foreign income tax purposes.

Example: CFC1 transfers Asset A to its wholly owned subsidiary in exchange for common stock and cash (a section 351 transaction with "boot"). Both the United States and foreign country view the transaction as an acquisition of Asset A. However, for foreign purposes there is no basis step-up while for U.S. purposes, the basis in Asset A is increased by gain recognized on the transaction. *(Prop. Reg. § 1.901(m)-2(e), Example 2).*

In general, an asset is a relevant foreign asset ("RFA") for purposes of section 901(m) if income, deduction, gain or loss with respect to the asset is *relevant* in determining

foreign income *immediately after* the CAA (or that would be taken into account if there were income, deduction, gain or loss at such time).

KPMG observation: The definition of an RFA in the proposed and temporary regulations differs from the statutory definition, which looks to assets in a CAA if income, deduction, gain or loss attributable to the asset is taken into account in determining foreign income tax.

The proposed regulation would also provide an anti-abuse rule to address situations where an asset is not relevant for foreign income purposes immediately after a CAA, but becomes relevant later pursuant to a transaction having a principal purpose of avoiding section 901(m). A principal purpose would be deemed to exist if income, deduction, gain or loss attributable to the asset is taken into account (or would be if there were income, deduction, gain or loss) within the one-year period following the CAA.

Example: On January 1, Year 1, USP2 acquires USS from USP1 (an unrelated corporation) and makes a section 338 election to step up the basis in USS's assets. The assets are not relevant foreign assets at that time because none of the income, deduction, gain or loss attributable to such assets is or would be taken into account in determining foreign income. On December 1, Year 1, USS contributes all of its assets to FSub, a wholly owned foreign subsidiary, in a section 351 transaction. No gain or loss is recognized for U.S. or foreign purposes. As a result of the section 351 transaction, the transferred assets are or would be taken into account in determining income, deduction, gain or loss for foreign income tax purposes. Because the section 351 transaction occurred within one year of the CAA, the principal purpose rule applies to treat the assets as RFAs.

KPMG observation: The proposed regulation would not preclude treating a subsequent transfer of assets more than one year after the CAA as giving rise to RFAs, but such a transaction would not be treated as per se having a principal purpose of avoiding section 901(m).

Prop. Reg. § 1.901(m)-3

Proposed Reg. § 1.901(m)-3 provides detailed computational rules for determining the amount of disallowed foreign taxes under section 901(m) (the "disqualified tax amount") and determining whether and how much of a basis difference assigned to a particular year carries over to the next year (the "aggregate basis difference carry over").

Disqualified Tax Amount

The disqualified tax amount is the lesser of the tentative disqualified tax amount of the of foreign tax paid or accrued, or considered paid or accrued, by the section 901(m) payor (defined as any person eligible to claim a section 901 credit and any section 902 corporation). Each member of a consolidated group is treated as a separate section 901(m) payor. The regulations modify section 901(m)(3) for purposes of computing the tentative disqualified tax amount, providing that such amount equals the foreign income tax paid or accrued for the year multiplied by a fraction, the numerator of which is the portion of the basis difference assigned to the section 901(m) payor for the tax year and the denominator of which is the amount of foreign income reflected on a foreign tax return that relates to the foreign income tax in the multiplicand.

While the statutory rule looks to foreign income and foreign taxes imposed with respect to the RFAs, the proposed regulations determine allocable income and taxes by looking to the total amount of foreign income and taxes allocable to a section 901(m) payor. The preamble indicates that the IRS and Treasury Department concluded that this approach carries out the statutory purposes while avoiding the administrative and compliance burdens that would result from having to trace income and taxes to specific assets.

A separate section 901(m) calculation must be made for taxes in each separate category as defined in Reg. § 1.904-4(m). In addition, if a foreign entity's income and taxes are allocable to more than one section 901(m) payor, each payor takes into account only its allocable share of income and taxes. Foreign income and taxes may be allocable to more than one section 901(m) payor, for example, if the foreign payor is a partnership for U.S. tax purposes, there is a mid-year acquisition or transfer of the foreign payor, or the foreign payor is a member of a foreign consolidated group.

If a section 901(m) payor cannot substantiate allocable foreign taxes to the satisfaction of the Secretary, allocable foreign income would equal the sum of the foreign income tax amount plus foreign corporation creditable taxes paid, accrued or deemed paid or accrued by the section 901(m) payor, divided by the highest tax rate under foreign law.

The disqualified tax amount for a year would be zero in three situations. First, if the section 901(m) payor's aggregate basis difference for the year is negative. Second, if foreign income is zero or a loss for the foreign tax year of the foreign payor, and third, if no foreign income taxes are paid, accrued or deemed paid or accrued by the payor for the U.S. tax year.

Aggregate Basis Difference Carryover

Under section 901(m)(3)(B), a taxpayer determines the basis difference in its relevant foreign assets and spreads that basis difference over the useful life of the assets. In general, absent a disposition that resulted in a basis differences carrying over to

another person, the assumption was that the portion of a basis difference assigned to a particular year remained in that year whether or not it resulted in disallowed taxes. The proposed regulations take a different approach.

Proposed Reg. § 1.901(m)-3(c) provides generally that the basis difference for a particular year would be carried over and included in the section 901(m) payor's aggregate basis difference for the next year (and thus included in the numerator of the disqualified foreign taxes ratio) to the extent the aggregate basis difference for a particular tax year has not yet given rise to a disqualified tax amount. The amount does not appear to be relevant.

If a section 901(m) payor's disqualified tax amount is zero, all of the aggregate basis difference for the year (whether positive or negative) carries over. If the disqualified tax amount is greater than zero, a basis difference carryover can still arise in two situations. First if the aggregate basis difference of the year exceed allocable foreign income (*i.e.* the disallowance fraction is greater than one), the excess carries over. Second, if the tentative disqualified amount exceeds the disqualified amount (*i.e.,* taxes paid or accrued are greater than the tentative disqualified amount), the excess tentative disqualified amount is converted in whole or in part into aggregate basis difference.

Proposed Reg. § 1.901(m)-4 and Reg. § 1.901(m)-4T

A basis difference is computed separately with respect to each foreign income tax for which an asset is an RFA. Thus, if an asset gives rise to a tax liability in two foreign countries, a separate basis differences must be computed for each. The temporary regulation sets out the statutory rule that the basis difference in an RFA is the U.S. basis in the RFA immediately after a CAA, less the U.S. basis immediately before the CAA. The proposed regulation provides an election to measure basis difference by reference to foreign basis. If the foreign basis election is made, the basis difference is the U.S. basis immediately after the CAA, less the foreign basis in the RFA immediately after the CAA. The foreign basis immediately after the acquisition takes into account any basis adjustments that may result from the CAA under foreign law.

In general, the RFA owner (U.S.) makes the foreign basis election, but if the RFA owner (U.S.) is a partnership, each partner may independently make a foreign basis election. The RFA owner (U.S.) is the person who owns the RFA for U.S. income tax purposes. The election is made separately for each CAA, with respect to each foreign income tax, and with respect to each foreign payor. If foreign law imposes tax on the combined income of a foreign group, all members of the group are treated as a single foreign payor.

The election is made by using foreign basis to determine basis difference. There is no specific form or statement required, but to be effective the election must be reflected on a timely filed *original* return (including extensions) for the first year in which it is relevant. In limited cases, an election on a partner's amended federal income tax return is permitted. In addition, if a taxpayer chooses to apply the proposed

regulations retroactively to CAAs occurring on or after January 1, 2011, a foreign basis election will be effective if made on a timely filed amended return filed no later than one year after publication of the proposed regulations in the Federal Register.

The foreign basis election would be irrevocable and section 9100 relief would not be available for a missed election.

Prop. Reg. § 1.901(m)-5 and Reg. § 1.901(m)-5T

The proposed and temporary § 1.901(m)-5 regulations provide rules for determining the amount of basis difference with respect to an RFA that is taken into account in a particular U.S. tax year. That amount then is used to compute the disqualified tax amount for the year.

Under the proposed regulations, basis difference taken into account would be computed under one of two rules. The general rule would determine the basis difference taken into account using the applicable cost recovery method for the RFA. Under this rule, cost recovery is assigned to the U.S. tax year of the section 901(m) payor in which the corresponding U.S. basis deduction is taken into account. For purposes of determining basis difference taken into account as a result of a disposition, a different set of rules applies. The temporary regulations incorporate the rules provided in Notice 2014-44 for this purpose.

The proposed regulations provide additional guidance on how to allocate and assign a cost recovery amount when the RFA owner (U.S.) is fiscally transparent. In addition, the proposed regulations would provide special rules for allocating the cost recovery amount or disposition amount in a section 743 CAA, where there is a mid-year transaction, and where the RFA owner (U.S.) is a reverse hybrid entity or a fiscally transparent entity (under U.S. or foreign law) directly or indirectly owned by a reverse hybrid entity.

Proposed Reg. § 1.901(m)-6 and Reg. § 1.901(m)-6T

Regulation § 1.901(m)-6T provides successor rules for the continued application of section 901(m) after an RFA that has an unallocated basis difference has been transferred. A successor transaction to which the temporary regulation applies is a transfer of an RFA for U.S. income tax purposes that occurs after a CAA if the RFA has an unallocated basis difference determined immediately after the transfer. A successor transaction may itself be a CAA, and any unallocated basis difference from the prior CAA will continue to be taken into account. If there have been more than one previous CAA, each is reviewed separately to determine whether there is an unallocated basis difference to be taken into account following a transfer of RFAs.

The proposed regulations would provide that if a foreign basis election is made in a subsequent CAA, any unallocated basis difference from one or more prior CAAs *is not* taken into account under section 901(m).

Finally, the proposed regulation would provide an anti-abuse rule applicable when there is a transfer of assets or a change in the allocation of income for U.S. or foreign purposes that has the principal purpose of separating foreign income tax amounts from the related aggregate basis difference carryover. As an example, the preamble cites an amendment to a partnership agreement to reduce the amount of foreign income allocated to a partner that is a section 901(m) payor with an aggregate basis difference carryover.

Proposed Reg. § 1.901(m)-7

Proposed Reg. § 1.901(m)-7 provides a helpful de minimis rule under which certain basis differences would not be taken into account under section 901(m) and thus would not give rise to disallowed foreign taxes. Under the de minimis rule, a basis difference with respect to an RFA arising from a CAA between unrelated parties is not taken into account under section 901(m) if either

- The sum of the basis differences for all RFAs with respect to a CAA is less than the greater of $10 million or 10% of the total U.S. basis of all RFAs immediately prior to the CAA; or

- The RFA is part of a class of RFAs (as described in Reg. § 1.338-6) for which the sum of the basis differences of all RFAs in the class is less than the greater of $2 million or 10% of the total U.S. basis for all RFAs in the class.

When a CAA acquisition occurs between related parties, the Treasury Department and IRS determined that transactions should be more tightly regulated, and the proposed regulation thus would set lower thresholds for application of the de minimis rule. A basis difference with respect to an RFA arising from a CAA between related parties is not taken into account under section 901(m) if either

- The sum of the basis differences for all RFAs with respect to a CAA is less than the greater of $5 million or 5% of the total U.S. basis of all RFAs immediately prior to the CAA; or

- The RFA is part of a class of RFAs (as described in Reg. § 1.338-6) for which the sum of the basis differences of all RFAs in the class is less than the greater of $1 million or 5% of the total U.S. basis for all RFAs in the class.

An anti-abuse rule would turn off the de minimis exception for transactions between related parties structured with a principal purpose of avoiding the application of section 901(m).

Proposed Reg. § 1.901(m)-8

Proposed Reg. § 1.901(m)-8 would provide two additional rules applicable to transactions implicating section 901(m). First, the regulation would clarify that section

901(m) and these proposed regulations apply to both foreign income taxes characterized as “post-1986 foreign income taxes” and to pre-1987 foreign income taxes, both as defined in Reg. § 1.902-1. Second, a proposed anti-abuse rule would ignore built-in loss RFAs in computed unallocated basis differences if any RFA is acquired with a principal purpose of using the built in loss RFA to avoid the application of section 901(m).

Read background and initial observations about the regulations: ***TaxNewsFlash-United States***

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