Treasury releases final Section 901(m) regulations

March 27, 2020

In brief

Treasury and the IRS on March 20 final regulations relating to the limitation on foreign tax credits (FTCs) for foreign taxes paid or accrued in connection with covered asset acquisitions (CAAs) under Section 901(m). Section 901(m) disallows a portion of the FTC attributable to a basis difference in assets acquired in a CAA. The final regulations are generally consistent with temporary and proposed regulations issued on December 6, 2016, with targeted revisions to address some comments received from taxpayers.

The previously effective temporary regulations expanded on the 'disposition rule' announced in Notice 2014-44 (July 21, 2014) and Notice 2014-45 (July 30, 2014), which allocate the basis difference attributable to a CAA to a US tax year, following a subsequent disposition. The temporary regulations also excluded withholding taxes from the scope of Section 901(m) and provided certain definitions necessary to apply Section 901(m).

The proposed regulations contained significant additional guidance, including: (1) three additional categories of CAAs; (2) rules that preserve/carry over a basis difference that otherwise would be allocated to a tax year when the basis difference, in whole or in part, would not have the effect of disqualifying foreign taxes from being claimed as a credit; and (3) an election to determine the basis difference arising from a CAA by comparing the US basis to the basis under foreign law.

The final regulations generally are effective for CAAs occurring on or after March 23, 2020, the date that they were published in the Federal Register. However, the portions of the final regulations relating to the 'disposition rule' are effective for CAAs that occur on or after the dates announced in Notices 2014-44 and 2014-45 (generally, July 21, 2014), and to any unallocated basis difference remaining from CAAs that occurred from January 1, 2011 to before July 21, 2014.

In detail

Background

Section 901(m), enacted in 2010, disallows the FTC for a portion of foreign taxes accruing with respect to assets acquired in a CAA (relevant foreign assets, or 'RFAs'). The Code describes three CAAs: (1) a qualified stock purchase for which an election under Section 338 is made; (2) any transaction that is treated as an asset acquisition for US tax purposes, but is treated as a stock acquisition (or is disregarded) for foreign tax purposes; and (3) any acquisition of a partnership interest for which a Section 754 election is in effect. Each of the statutorily prescribed CAAs generally increase the US tax basis in RFAs without increasing the foreign tax basis. As a result of the stepped-up basis, US taxable income following a CAA generally is less than foreign taxable income, whether because of increased US cost recovery deductions or reduced gain on a subsequent asset sale.

To address this discrepancy, Section 901(m) prevents taxpayers from claiming a FTC for the 'disqualified portion' of any foreign income tax - that is the proportion of the foreign tax equal to the ratio of (1) the portion of the basis difference attributable to the CAA taken into account in the current year to (2) the foreign taxable income in the current year. While not creditable, the disqualified portion of any foreign tax is deductible, even if the taxpayer otherwise elects to credit foreign taxes for the tax year.

Additional Section 901(m) guidance was provided in Notices 2014-44 and 2014-45 to address application of the so-called disposition rule under Section 901(m). In the Notices, Treasury and the IRS set forth rules as to when an event constitutes a 'disposition' of an RFA for purposes of Section 901(m), and announced their intention to incorporate such rules in future regulations. In December 2016, Treasury and the IRS issued temporary regulations, which generally followed the guidance announced in the 2014 notices, and proposed regulations, which provided a more comprehensive regulatory framework for Section 901(m).

For a more complete discussion of Section 901(m), and the temporary and proposed regulations, see our prior PwC Tax Insight: Temporary and proposed Section 901(m) regulations relate to non creditable foreign taxes for covered asset acquisitions (December 19, 2016).

Highlights of final regulations

The final regulations generally follow the 2016 temporary and proposed regulations, while adding an exception for CAAs involving members of consolidated groups and minor technical revisions. However, in adopting the framework of the proposed regulations, the final regulations expand the circumstances in which post-CAA basis differences are associated with foreign taxes, thereby increasing the disallowance of FTCs.

Scope of covered asset acquisitions

The final regulations add three new CAAs that had been described in the proposed regulations - namely any transaction, or series of transactions, that is treated as (1) an acquisition of assets for US tax purposes and as the acquisition of an interest in a transparent entity for foreign tax purposes; (2) a partnership distribution that increases the US basis of either distributed assets under Section 732(b) or (d) or the partnership's remaining assets to be adjusted under Section 734(b); or (3) an acquisition of assets for both US and foreign tax purposes that causes the US tax basis, but not the foreign tax basis, to increase.

***Observation*:** While comments requested an exception for acquisitions in which both parties are part of the same US-parented group, the final regulations do not provide any generally applicable exceptions to the CAA definition. Instead, the final regulations limit the impact of Section 901(m) on intra-group transactions by adjusting the aggregate basis difference resulting from a CAA by the amount of gain recognized by a corporation that is a member of the same consolidated group as the taxpayer of otherwise disqualified foreign taxes.

Allocation of basis difference to a US tax year

The most complex portions of the final regulations govern allocation of the aggregate basis difference arising from a CAA to one or more US tax years. Because of differences between US and foreign tax law, US and foreign tax law may treat different persons as (1) owning an RFA; (2) accruing cost recovery deductions with respect to the RFA; and/or (3) owing

foreign tax generated by the RFA. Under the default rule, if the same person owns the RFAs and accrues foreign tax for US and foreign tax purposes, a portion of the aggregate basis difference is allocated to the tax year to the extent that the taxpayer depreciates or amortizes an RFA or disposes of an RFA. If, however, the RFA owner is a fiscally transparent entity owned by the technical taxpayer for US tax purposes, detailed technical rules apply to allocate a portion of the basis difference attributable to each cost recovery deduction and disposition to the technical taxpayer.

The final regulations maintain the disposition rules found in the temporary and proposed regulations. In the absence of timing differences, if the taxpayer disposes of an RFA in a transaction that is taxable for US and foreign tax purposes (i.e., the disposition results in all gain or loss, if any, being recognized with respect to the RFAs), the entire aggregate basis difference is allocated to the year of the disposition.

However, several exceptions apply. If the RFA is disposed of in a transaction that is not fully taxable for US or foreign purposes, the disposition can cause unallocated basis difference to be allocated to the year of the disposition, up to the amount of the foreign tax gain and the US tax loss resulting from the disposition. Another special rule applies to 'mid-year transactions' - transactions in which a foreign-law taxpayer that is a corporation or disregarded entity either closes its US tax year or is transferred, without closing its foreign tax year. If there is a disposition of an RFA following a mid-year transaction, the disposition amount is allocated among the tax years of transferor and transferee in proportion to the foreign tax imposed on the disposition.

Observation: The final regulations contain special rules that allocate basis difference when an RFA is held through a reverse hybrid entity or with respect to a CAA resulting from a Section 743(b) adjustment. Each of these special rules is an attempt by Treasury and the IRS to allocate basis differences (whether arising from cost recovery deductions or dispositions) to the US tax year of the person that the US tax laws view as the technical taxpayer to which the related foreign tax accrues.

Aggregate basis difference carryover

The final regulations also adopt the proposed regulations' concept of an aggregate basis difference carryover, which is designed to ensure that the entire aggregate basis difference has the effect of disallowing some amount of foreign income tax accrued by a foreign-law taxpayer from being claimed as a credit.

The regulations identify three circumstances where the basis difference allocated to a tax year does not result in maximum disallowance of foreign tax, and so the unused portion is carried to the subsequent tax year. First, if the amount of foreign taxes disqualified in a tax year is zero - including circumstances where no foreign taxable income exists, the foreign income taxed paid or accrued is zero, or the basis difference allocated to the tax year is negative - all of the basis difference carries over to the following year. Second, if some foreign tax is disallowed as a credit with respect to the tax year, but the basis difference allocated to a tax year exceeds the foreign taxable income for the year, the excess basis difference carries over. Finally, if some foreign tax is disallowed as a credit with respect to the tax year, but the expected amount of foreign taxes that should be disallowed (referred to as the 'tentative disqualified tax amount' in the regulations) exceeds the amount of actual foreign taxes disallowed, the excess is converted into an amount of allocable basis difference that is carried to the following year.

Foreign basis election

Generally, the aggregate basis difference with respect to an RFA is the amount by which the US tax basis increased as a result of the CAA (i.e., the US tax basis immediately after the CAA as compared to the US tax basis immediately before the CAA). However, the final regulations contain an irrevocable election that also takes into account a foreign basis step-up in an RFA. A taxpayer that makes the foreign basis election determines the aggregate basis difference by comparing the US tax basis in an RFA immediately after the CAA to the foreign tax basis in an RFA immediately after the CAA.

The foreign basis election may be made by the person that, following the CAA, is treated as the owner of the RFA for US tax purposes. If the owner is a partnership, each partner may make the foreign basis election independently. The election is made simply by using foreign basis to determine the aggregate basis difference on the taxpayer's timely filed return for the first year that the basis difference is relevant to any amount determined on the return. No separate election statement is required.

Observation: Taxpayers generally may choose whether to make the foreign basis election for each CAA independently. However, in order to make the foreign basis election for a CAA that occurred before the final regulations become effective, taxpayers generally must apply the provisions of the proposed regulations to all CAAs since the proposed regulations were published. Taxpayers that engaged in one or more CAAs in a tax year that is now closed may make the retroactive foreign basis election, but doing so requires both amending open tax years to apply the provisions of the proposed regulations and making adjustments to those years to take into account the net cost of applying the proposed regulations to closed tax years.

Successor rules

The final regulations also adopt the temporary and proposed regulations' successor rules, without significant revisions. The successor rules require the acquirer of an RFA in a post-CAA transaction to continue to take into account any unallocated basis difference with respect to the RFA that arose in the original CAA, regardless of whether the acquisition causes gain or loss to be recognized with respect to the RFA, or alters the RFA's basis in the hands of the acquiror. Furthermore, on the acquisition of substantially all the assets of a foreign taxpayer, or the assets of a US technical taxpayer in a Section 381 transaction, the acquiror generally succeeds to any aggregate basis difference carryover.

Observation: Notwithstanding the adoption of the successor rules contained in the temporary regulations, the successor rules applicable to the aggregate basis carryover provisions apply only to aggregate basis differences that arise with respect to CAAs that occur on or after the effective date of the final regulations (i.e., CAAs occurring on or after March 23, 2020).

Miscellaneous

- Interaction with Section 909: the final regulations confirm that Section 909 applies before Section 901(m). Section 901(m) does not apply to disqualify foreign taxes subject to a splitter arrangement until Section 909 permits the taxes to be unsuspended and taken into account.
- Changes related to the 2017 tax return legislation: The temporary and proposed regulations applied to foreign corporations that were members of a Section 902 qualified group. For periods since the repeal of Section 902, the final regulations confirm that Section 901(m) applies to any controlled foreign corporation.
- De minimis basis difference in RFAs: In addition to previously proposed rules providing an exception to Section 901(m) for RFAs that are part of an asset class with an aggregate basis difference of less than $2 million or 10% of the total value of the asset class, the final regulations provide a general exception for any RFA with a basis difference under $20,000. In addition, the final regulations eliminate the increased thresholds contained in the proposed regulations that applied with respect to related-party transactions.

The takeaway

The disallowance of FTCs under Section 901(m) can have a material effect on the economics of cross-border M&A, as well as related-party transactions. . The final regulations are complex and can require significant analysis to apply even to straightforward transactions. Furthermore, the newly adopted aggregate basis difference carryover and successor rules may limit taxpayers' ability to mitigate the impact of Section 901(m). Now that the regulations are effective for all taxpayers, businesses should consider the impact of Section 901(m) on all cross-border transactions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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