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Unpacking the New §901(m) Proposed Regulations

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INTRODUCTION

Temporary and proposed regulations under §901(m)[2] were issued as part of the deluge of guidance at the end of the Obama administration. With the exception of temporary regulations addressing certain limited topics,[3] the comprehensive new regulations under §901(m) were issued only in proposed form and with a prospective effective date.

Yet ''covered asset acquisitions'' subject to §901(m) remain a regular occurrence in international mergers and acquisitions (''M&A''), and the proposed regulations may provide clarifications on certain issues in applying §901(m). In addition, the drafters of the proposed regulations, perhaps foreseeing that the proposed regulations might languish before adoption, include reliance language to allow taxpayers to rely on the proposed regulations immediately, subject to applying the proposed regulations in their entirety to all covered asset acquisitions occurring after January 1, 2011. For taxpayers that would like to begin to rely on positive provisions in the proposed regulations, they must ''take the bitter with the sweet.''[4] Therefore, in deciding whether to apply any part of the proposed regulations, a taxpayer needs to have a complete grasp of the relevant provisions.

What follows is a review and detailed analysis of the proposed regulations, in all of their good, bad, and indifferent features, from the perspective of a taxpayer contemplating early adoption of the proposed regulations.

BACKGROUND ON §901(m) AND CAAs

Section 901(m) was enacted as part of a series of foreign tax credit changes in 2010, including §909 and §960(c). It was brought into the Code to prevent the step-up in U.S. basis in certain acquisition transactions (''covered asset acquisitions'') from increasing the foreign tax credit. The remedy where §901(m) applies is to disallow permanently a portion of the foreign income taxes imposed with respect to the assets that were acquired in the covered asset acquisition (''CAA''). The disqualified portion is generally the taxes paid multiplied by the additional step-up in the assets for U.S. tax purposes, as a fraction of the foreign taxable income attributable to the relevant foreign assets. The disqualified portion of the taxes is intended to cause the allowable foreign tax credit, as a

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The author thanks Jim Fuller for his review and comments on this paper. Any views expressed herein are solely those of the author, not his firm, and any errors and omissions are the author's sole responsibility.

[2] REG-129128-14, 81 Fed. Reg. 88,562 (Dec. 7, 2016). All section references are to the U.S. Internal Revenue Code, as amended (the ''Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[3] T.D. 9800, 81 Fed. Reg. 88,103 (Dec. 7, 2016).

[4] *Arnett v. Kennedy*, 416 U.S. 134, 154 (1974) (Rehnquist, J.) (plurality opinion).

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fraction of the foreign payor's taxable income or earnings and profits (''E&P''), to result in a lower effective foreign tax rate for foreign tax credit purposes. It is easiest to see the impact of §901(m) in a simple example.

> *Example.* For $90 million in cash, a U.S. corporation (''USP'') acquires all of the stock of a foreign target (''FT'') located in Germany. Assume that FT has zero basis in its assets prior to the acquisition and zero liabilities. USP makes a §338(g) election for the stock purchase, causing FT to be treated, for U.S. tax purposes, as selling all of its assets to a new FT owned by USP for a deemed sale price of $90 million. From a German perspective, FT earns taxable income of $12 million and pays $3 million in German tax (i.e., a 25% statutory German tax rate). However, from a U.S. tax perspective, assume that FT has an additional $6 million of amortization deductions under §197, so that its E&P (assuming no E&P adjustments) is $3 million ($12 million taxable income, minus $6 million of amortization, minus $3 million of German tax). Before taking into account §901(m), FT has $3 million of creditable foreign income taxes and $3 million of E&P, for an effective foreign tax rate of 50% from a §902 perspective.

The stock purchase of FT with a §338(g) election is a covered asset acquisition, and causes a portion of FT's taxes to be disallowed as a credit equal to $3 million of total taxes multiplied by $6 million of additional amortization deductions / $12 million of foreign taxable income or $1.5 million. The remaining $1.5 million of foreign income taxes are creditable. The $1.5 million of taxes disallowed as a credit are allowed to FT as a deduction in computing its E&P.[5] Thus, as a result of applying §901(m), FT has $1.5 million of creditable foreign income taxes and $3 million of E&P, for an effective foreign tax rate in its §902 pools of 33%.

In addition, in a scenario where the entity disposes of its foreign assets, accelerating a foreign taxable gain, §901(m) generally causes the remaining basis difference to be taken into account, so that a larger fraction of the taxes are disallowed. For example, assume that in the prior example, sometime after closing, FT sold all of its assets to an affiliate for $80 million, recognized a German taxable gain of $80 million and paid $20 million of foreign tax. In this scenario, assuming that $80 million of the total of $90 million of basis difference had not been previously taken into account, FT's entire tax on the $80 million gain would be disallowed under §901(m).

[5] §901(m)(6).

CAAs AND RFAs: DEFINITIONAL MATTERS

CAA Categories

Under the statute, the categories of transactions covered by §901(m) include:

- a qualified stock purchase as to which an election is made under §338(g) of the Code,
- a transaction which is treated as an acquisition of assets for U.S. tax purposes and an acquisition of stock (or disregarded) for foreign tax purposes (such as an acquisition involving a check-the-box election), and
- an acquisition of an interest in a partnership with a §754 election in effect.[6]

In addition, Congress grants to the Internal Revenue Service, in regulations, authority to identify additional ''similar'' transactions that are subject to §901(m).[7]

The proposed regulations exercise this authority to broadly expand the scope of §901(m). First, the proposed regulations include within the scope of §901(m) an acquisition of an interest in a partnership or other pass-through entity that is treated as a purchase of assets for U.S. tax purposes, but as a purchase of interests for foreign tax purposes.[8] Second, the proposed regulations include a step-up in basis of a partnership's assets by virtue of gain recognized under §732(b) or §732(d), or under §734(b), as a covered asset acquisition (as in the sale category, the partnership must have a §754 election in effect for this step-up to be available). Third, the proposed regulations include, as a CAA, ''any transaction (or series of transactions occurring pursuant to a plan) 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 or more assets.''[9]

The first two new categories seem to be relatively modest extensions of the statute, given their similarity to the original second and third categories of CAAs. For example, the proposed regulations illustrate that the purchase of all of the interests of a foreign law

[6] *See* §901(m)(2).
[7] §901(m)(2)(D).
[8] Prop. Reg. §1.901(m)-2(b)(4).
[9] Prop. Reg. §1.901(m)-2(b)(6).

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partnership (not a hybrid) would be a CAA.[10] This result is not surprising given that a purchase of some but not all of the interests in the same partnership (with a §754 election) would be a CAA.

The third category, however, marks a significant expansion of CAA status. The Example in the proposed regulations illustrates that this new category would apply to a transfer of assets in a §351 transaction, where the U.S. considers ''boot'' to have been paid, but the foreign tax law views the transactions as entirely tax-free.[11] This new category would cause seemingly any transfer of assets that resulted in a basis difference to be treated as a CAA. This is in contrast to the statutory categories, all of which involve some form of U.S. tax election to achieve the hybrid treatment. Thus, it is questionable that this transaction really is ''similar'' to the other transactions listed as CAAs.

This last new category also underscores that the taxpayer can have a CAA even if the U.S. basis step-up was at the cost of having to pay full U.S. tax on the gain that led to the step-up. For example, this new category would seem to apply to an outbound transfer of assets that triggers current recognition of gain under §367(a).[12] This does not seem right.

Relevant Foreign Assets

The new proposed regulations also provide that relevant foreign assets (''RFAs'') are considered to be those that produce items of income, deduction, gain or loss relevant to a foreign income tax in a jurisdiction on the date of the CAA.[13] Thus, RFA status is generally determined once and for all as of the acquisition date, and the §901(m) taint with respect to one foreign income tax applicable to the assets on that date generally does not apply to other foreign income taxes.

However, in a significant exception to this rule, the proposed regulations provide that assets may become RFAs with respect to another income tax if they are transferred to another jurisdiction subsequent to CAA with a principal purpose of avoiding §901(m).[14] A principal purpose of avoiding §901(m) will be deemed to exist if the assets are transferred in the 12 months following the CAA so that they become relevant for purposes of another foreign income tax. Thus, in an internal restructuring occurring with 12 months of the date of CAA, the movement of assets to the new jurisdiction will cause §901(m) to apply in that new jurisdiction.[15]

Example 3 in the proposed regulations[16] illustrates that this subsequent transfer rule may apply even where the CAA itself is a purely domestic acquisition. There, the U.S. target is acquired in a qualified stock purchase with a §338(h)(10) election. Surprisingly, the example states that this purely domestic acquisition is a CAA. The CAA status of the transaction initially has no effect, however, because the assets of the U.S. target are relevant only for purposes of U.S. tax. In the example, later in the same taxable year, U.S. target then contributes the assets to a foreign target in a §351 contribution. Since this transfer occurs within 12 months of the CAA, it is deemed to be effected with a principal purpose of avoiding §901(m) and causes the assets to become RFAs in the foreign transferee's jurisdiction. Although framed as an anti-abuse rule, the proposed regulations' 12-month test is a conclusive presumption. What would happen if the U.S. purchaser in this example were party to a qualified cost-sharing arrangement and required to transfer IP to a foreign party as a ''platform contribution transaction'' under Reg. §1.482-7(g)? The foreign entity acquiring an interest in the intangibles as required under the cost-sharing regulations might now be subject to §901(m) on the grounds that it has acquired assets with a conclusive presumption of avoiding §901(m).

MEASURING THE AGGREGATE BASIS DIFFERENCE

Once a covered asset acquisition has occurred, the ''aggregate basis difference'' is a key variable in 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 based on the difference between U.S. and foreign basis as a fraction of the taxpayer's foreign income. The basis difference, in other words, is the additional tax basis ''step-up'' that §901(m) attempts to reverse out for foreign tax credit purposes.

By statute, the term ''basis difference'' means the difference between the ''adjusted basis'' of the RFA immediately after the CAA and the adjusted basis of

[10] Prop. Reg. §1.901(m)-2(e) *Ex.* 1.

[11] Prop. Reg. §1.901(m)-2(e) *Ex.* 3. For example, this result could apply if the foreign target issued equity that constituted nonqualified preferred stock under §351(g).

[12] The proposed regulations do not include any exception from CAA status for transactions where the related gain is, or will be, reported as U.S. taxable income by the seller/transferor.

[13] Prop. Reg. §1.901(m)-3(c)(1).

[14] Prop. Reg. §1.901(m)-3(c)(2).

[15] 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 may 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 first foreign jurisdiction.

[16] Prop. Reg. §1.901(m)-3(e) *Ex.* 3.

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such RFA immediately before the CAA.[17] Section 901(m) does not provide a special definition of the term ''adjusted basis'' and, in the legislative history, Congress indicated that it intended to refer to the U.S. tax basis of the asset (absent regulations to the contrary).[18]

The proposed regulations provide relief from the need to reconstruct U.S. tax basis of a foreign target through the ''foreign basis election.'' Under the election, in lieu of measuring the U.S. tax step-up in the assets resulting from the CAA, the taxpayer compares the difference between U.S. tax basis and foreign tax basis in the assets immediately *after* the CAA.[19] Foreign tax basis in the assets immediately after the CAA specifically includes any step-up for foreign tax purposes resulting from the CAA itself.[20]

The foreign basis election would likely be helpful in two ways. First, the use of foreign basis to measure the ''step-up'' in the CAA will be a matter of administrative convenience. Under the general rule, the taxpayer will need to reconstruct U.S. tax basis of a foreign entity that has been wholly outside the U.S. tax system, depriving the taxpayer of the ''clean slate'' that was one of the benefits of having made a §338(g) election. While there no doubt will be opportunities to minimize the basis difference by studying the target's U.S. tax history,[21] many taxpayers will likely choose the foreign basis election for ease of administration. However, since the foreign basis election is optional, taxpayers will still have the ability to study U.S. tax basis for particular CAAs to determine whether it is advantageous on particular facts and circumstances. Taxpayers may also need to determine the pre-close U.S. tax basis of the target to understand what they are giving up by making the foreign basis election. It could be costly.

Second, the fact that foreign basis is measured *after* the CAA, rather than *before* the CAA, avoids perverse results where there is a corresponding foreign tax step-up from the transaction. To the extent there is a corresponding foreign tax basis step-up, there is no ''basis difference'' in the future between U.S. and foreign tax basis. Yet if the general statutory formula is interpreted to refer to U.S. tax basis, §901(m) would nonetheless seem to disallow foreign tax credits. The foreign basis election could provide a taxpayer significant relief in this situation.

The election generally must be made on a timely filed original return for the first year for which the election is ''relevant'' to the computation of any amounts shown on that return.[22] No §9100 relief will be available for failure to make the election,[23] although special transition rules are provided for taxpayer to make the election in connection with early adoption of the proposed regulations, as discussed below.

As noted above, the proposed regulations would allow the taxpayer to make, or not make, the foreign basis election with respect to each foreign entity subject to CAA in a multi-entity acquisition.[24] Prop. Reg. §1.901(m)-4(f) Example 1 illustrates this rule. In the example, the taxpayer acquires CFC1 and CFC2 with a §338 election for each entity. CFC1 also owns DE1 and DE2. According to Example 1, there are four separate CAAs. CFC1 can make the foreign basis election for its own assets, the assets of DE1, and/or the assets of DE2. Also CFC2 can make the foreign basis election for its RFAs. Thus, the taxpayer would be free to determine, on a legal entity by legal entity basis, whether it is advantageous to use U.S. or foreign basis to measure the basis difference. The taxpayer would not, however, be able to make the foreign basis election separately for different assets within a single ''foreign payor.''[25]

CALCULATING THE DISQUALIFIED TAX AMOUNT AND ABD CARRYOVER

Once a CAA has occurred and the basis difference been determined, the taxpayer must apply the §901(m) formula to determine the foreign income taxes that are disqualified. The proposed regulations introduce several new complex formulae to allocate the basis difference country by country, so as to disallow foreign income taxes as a credit, account for the possibility that branch taxes disallowed under §901(m) may also be creditable in a foreign entity's home country and reduce taxes, and provide for a novel ''ABD carryover amount'' to address situations where under the proposed regulations the full portion

[17] §901(m)(3)(C)(i).

[18] J. Comm. on Tax'n, *Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010* (JCX-46-10) (Aug. 10, 2010).

[19] Prop. Reg. §1.901(m)-4(c)(1).

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

[21] *See* Fuller and Halpern, *Some Further Thoughts on Covered Asset Acquisitions: Can the IRS Save Us (and Itself) from Code Sec. 901(m)?* Int'l Tax J. (June 2011).

[22] Prop. Reg. §1.901(m)-4(c)(4).

[23] Prop. Reg. §1.901(m)-4(c)(7).

[24] Prop. Reg. §1.901(m)-4(c)(3).

[25] Also, there appears to be an unstated assumption in the Example that the entities above do not file a foreign combined return, as a separate rule in Prop. Reg. §1.901(m)-4(c)(3) treats foreign entities computing their income on a group basis as a single foreign payor for §901(m) purposes. Entities within a single foreign group apparently would not be permitted to make separate foreign basis elections.

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of foreign income taxes are not disallowed in a year to reflect the recovery of the basis difference.

The Disqualified Tax Amount Formula

Section 901(m)(1) provides for disallowance as a credit the disqualified portion of any foreign income tax ''determined with respect to the income or gain attributable to the relevant foreign assets.'' Similarly, the disqualified portion formula in §901(m)(3)(A) similarly refers to the income or gain ''attributable to'' the relevant foreign assets. Under the plain meaning of the term, ''attributable to'' would seem to suggest some sort of causal link between the income and taxes, on the one hand, and relevant foreign assets on the other hand.[26] This would seem to imply that the taxes subject to disallowance under §901(m) could be traced in some manner to the assets acquired in the CAA.

The proposed regulations, by contrast, ignore any tracing and instead apply the formula on a country-by-country basis to all income and foreign tax in the country. This approach is justified by the Preamble on the grounds of administrative simplicity.[27] As illustrated by Example 3, discussed below, under the proposed regulations' approach, which indeed may be easier, §901(m) could disallow income and tax from assets entirely unrelated to the CAA. This provides a broad gloss on the term ''attributable to.''

Prop. Reg. §1.901(m)-3(b)(3) Example 3 illustrates the proposed regulations' approach to measuring income attributable to the RFAs in the context of a foreign entity with ''Post-Transaction Assets.'' In Example 3, a Country F CFC owns RFAs in a third-country branch on the date of the CAA and accordingly has a §901(m) disallowance associated with the Country G taxes, as well as any residual home country taxes on the branch's income after the credits for the Country G tax (Foreign Country Creditable Taxes — ''FCCTs''). Subsequent to the CAA and in an unrelated transaction, the CFC buys other assets in Country F that produce income. The example calculates the §901(m) disqualified tax amount in Country F by including both the income from the Country G branch assets and Country F assets of the CFC in a single formula, despite the fact that the Post-Transaction Assets are unrelated to the Country G assets (even being located in a different country), so that the income and tax from the assets are not in the common sense of the word ''attributable to'' the assets acquired in the CAA.

In a case where the RFAs produce losses, the approach of the proposed regulations leads to a harsh result. As a hypothetical, assume that a foreign disregarded entity (''FDE'') in Germany was acquired in a transaction that constituted a CAA. FDE owns Business 1 assets, including §197 intangibles with a $150 aggregate basis difference that produce $10 of additional amortization deductions each year for U.S. tax purposes. Two years later, FDE acquires assets making up a different line of business (''Business 2''). Business 2 generates $10 of taxable income and FDE incurs $3 of foreign tax (30% rate). Assume further that Business 1 operates at a break-even for the year and thus generates no foreign income or foreign tax. Under the formula in the Proposed Regulations, all of FDE's $3 of foreign income taxes would be disallowed because the basis difference, $10, is the same as FDE's foreign income for the year, $10, notwithstanding that the Business 1 assets comprising the RFAs do not produce any taxable income or themselves result in any foreign tax.

Details of the Disqualified Tax Amount Formula

The disqualified portion of a foreign tax is calculated as the lesser of two amounts: (i) the ''foreign income tax amount'' or (ii) the ''tentative disqualified tax amount.'' The foreign income tax amount is defined as the amount of foreign tax reflected on the foreign tax return, as amended or adjusted.[28] This effectively caps the disqualified tax amount for a year at the total foreign income taxes paid or accrued by the relevant entity in that year.

The tentative disqualified tax amount is defined as the difference between two amounts, i.e., quantity (A) minus quantity (B).[29] Quantity (A) is equal to the product of: (i) the foreign income tax amount and the Foreign Country Creditable Taxes (''FCCTs'')[30] in the relevant country, and (ii) a fraction, the numerator of

[26] *See, e.g., Braunstein v. Commissioner*, 374 U.S. 65, 70 (1963) (used in its ''ordinary meaning'' in collapsible corporation provisions, ''the phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question.' ''); *ElectroLux Holdings, Inc. v. United States*, 491 F.3d 1327, 1330–31 (Fed. Cir. 2007) (''The phrase ''attributable to,'' though it appears in many provisions of the Internal Revenue Code, is not defined anywhere in the Code and has no special technical meaning under the tax laws. Courts in various tax cases have construed the phrase according to its plain meaning, which is understood to be 'due to, caused by, or generated by.' '').

[27] REG-129128-14, 81 Fed. Reg. 88,562 (Dec. 7, 2016) Preamble IV.A.

[28] Prop. Reg. §1.901(m)-1(a)(22). In the case of a combined or group filing, the foreign income tax amount is determined on a groupwide basis.

[29] Prop. Reg. §1.901(m)-3(b)(2)(ii).

[30] FCCTs effectively are foreign taxes imposed by a third jurisdiction that are allowable as a credit in the country where the payor of the §901(m) tax is located (i.e., where the §901(m) payor

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which is the aggregate basis difference and the denominator of which is the allocable foreign income. Quantity (B) is equal to the amount of FCCTs that are a disqualified tax amount at the FCCT payor level.

In a situation without FCCTs, this formula is similar to the statute (other than dispensing with tracing, as discussed above). *See* Prop. Reg. §1.901(m)-4(b)(3) *Ex.* 2. It multiplies the foreign income tax in a country where the RFAs are relevant by the basis difference recovered for that year as a fraction (not to exceed 1) of the foreign income in the country. The test is applied separately on a country-by-country basis where the RFAs are relevant in computing foreign tax.[31]

The proposed regulations provide an additional set of rules for situations where the payor of taxes disallowed under §901(m) also pays FCCTs. FCCTs are foreign income taxes[32] that, with respect to a foreign income tax amount disqualified under §901(m), are claimed as a credit for local country purposes. These provisions would be relevant where the foreign entity acquired in the §901(m) transaction operates in a foreign country with a worldwide tax system, such as the United States. Where FCCTs are applicable in a §901(m) situation, the special rules regarding FCCTs prevent a double disallowance of foreign tax credits under §901(m). At the same time, the FCCT calculations continue to disqualify any residual foreign tax (after credit for FCCTs) under §901(m). As illustrated by the regulations' sole example of the FCCTs rule, the rules will ratchet up the complexity of the §901(m) calculation exercise.

Prop. Reg. §1.901(m)-3(b)(3) Example 3, discussed above, illustrates the application of the FCCTs rule where DE1, in Country F, owns a Country G branch with RFAs producing $100 of foreign taxable income and having a $100 basis difference recovered per year. DE1 initially has no other assets. Both Country F and Country G impose a 30% income tax, and Country F imposes tax on the branch assets after allowing a foreign tax credit. In a later transaction, DE1 acquires ''Post-Transaction Assets'' in Country F that produce an additional $100 of foreign income and have no ABD. Country F allows a foreign tax credit for the $30 of Country G taxes imposed on the branch, so that DE1 pays a total of $30 of Country F tax, after credit for tax.

Section 901(m) applies first to the Country G branch and results in all of its $30 of foreign income taxes being disallowed.

Next, at the Country F level, the §901(m) calculation takes into account the special rule for FCCTs. DE1's foreign income tax amount is $30, its post-credit foreign tax. None of this amount is disallowed under the rule for FCCTs because all of the Country G taxes are disallowed as a credit under §901(m), and the Country F tax rate is less than or equal to the Country G tax rate. Thus, in the example, there is no incremental §901(m) disqualification amount at the Country F / DE1 level.

If, however, the facts changed from the fact pattern illustrated in Example 3, the FCCTs rule would result in an additional disallowance. For example, consider the impact of the FCCTs rule if Country G's tax rate were only 20% and Country F's tax rate were 30%. Here, the results would be same at the Country G level, with all $20 of foreign taxes disallowed under §901(m). At the Country F level, however, there would now be a disqualified tax amount of $10, which effectively represents the 10% residual country F tax on the Country G branch's RFAs.[33] Also, what would happen if DE1 owned assets acquired in a CAA, and then acquired Post-Transaction Assets in the Country G branch? And, how would the rule work if the Country G branch were a subsidiary paying dividends subject to tax in Country F after a foreign tax credit? The one example of the FCCTs rule in the regulations only scratches the surface of the FCCT calculations.

ABD Carryover

The proposed regulations also provide an entirely new concept of an ''ABD carryover.''[34] This rule applies when the RFA owner's foreign income tax or allocable foreign income is insufficient to absorb the entire ABD for year. The apparent theory is the taxpayer has not disqualified sufficient taxes in the year when part of the basis difference is recovered, and accordingly, must increase its ABD and potential disqualified tax amount in subsequent periods. Conversely, if the ABD for the year is negative, the negative ABD will also carry over to the subsequent taxable year to potentially lessen the foreign tax credits disqualified under §901(m).[35] The ABD carryover effectively turns the annual computation of the disqualified tax amount in the statute into a multi-year affair.

is subject to a worldwide tax system, like the United States). The treatment of FCCTs and their impact on the calculation are discussed further below.

[31] *See, e.g.,* Prop. Reg. §1.901(m)-3(b)(3) *Ex.* 3(ii)(B).

[32] For purposes of determining FCCTs, foreign income taxes include foreign withholding taxes. *See* Prop. Reg. §1.901(m)-1(a)(17). Foreign taxes allowable, but not claimed as a credit, would not seem to be treated as FCCTs.

[33] This would be calculated on the hypothetical alternative facts as $60 of Country F tax (pre-credit) multiplied by $100 ABD / $200 of Country F taxable income ($30) minus $20 of Country G FCCTs that were disallowed.

[34] *See* Prop. Reg. §1.901(m)-3(c).

[35] Prop. Reg. §1.901(m)-3(c)(2)(i) (parenthetical reference to positive or negative basis differences).

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Under the proposed regulations, the taxpayer's entire ABD for a year (positive or negative) will become an ABD carryover if the taxpayer's disqualified tax amount for the year is zero.[36] The taxpayer may also have a partial ABD carryover. This will occur if the taxpayer's ABD for the year exceeds its allocable foreign income, in which case the excess becomes an ABD carryover.[37] Alternatively, if the ''tentative disqualified tax amount'' exceeds the actual disqualified tax amount, this excess is converted into an amount of ABD carryover by dividing the excess tax amount by the relevant foreign tax rate.[38] In short, in these cases, part of the ABD for the year becomes a carryover if it is not fully ''absorbed'' to result in a disallowance of foreign income taxes.

In the example of the ABD carryover amount,[39] the RFA owner is acquired midway through the U.S. taxable year and recovers 9u of basis difference under U.S. cost recovery principles. Due to a difference in the U.S. and foreign taxable years, no foreign taxes are accrued as a credit in that year. Thus, the disqualified tax amount for that year is zero (because there are no taxes to disallow). Accordingly, the entire 9u of basis difference recovered in the year becomes an ABD carryover to the following year. For the next year, the RFA owner has an ABD equal to its cost recovery amount for that year of 18u, plus the ABD carryover of 9u, or 27u. Ultimately, in a year in which the foreign income exceeds the ABD, a larger portion of foreign income taxes will be disallowed as a result of the carryover amount.

Although illustrated in a fact pattern of a split U.S./ foreign tax year end, the ABD carryover rule could apply where the foreign target company has net operating losses. Until the NOLs are absorbed and the target begins paying foreign income tax, the basis differences being recovered under §901(m) will accumulate and lead to a larger disallowance once the RFA owner begins paying foreign tax.

SUCCESSOR RULES AND DISPOSITIONS

While most of the regulations under §901(m) are issued only in proposed form, immediately effective temporary regulations apply to determine the disposition amount with respect to CAA. The disposition rules are issued in temporary form because they implement IRS Notice 2014-44 and Notice 2014-45.

The disposition rules generally apply where, following a CAA, the foreign entity disposes of the assets that are RFAs. In the case of a disposition, §901(m)(3)(B) provides that the entire basis difference generally is allocated to the taxable year in which the disposition occurs. The apparent rationale of §901(m)(3)(B) is that a disposition may cause the foreign gain built into the relevant foreign assets to be immediately recognized so that there is no longer any basis difference to take into account. The following is a simple example to illustrate the purpose of the disposition rule.

> *Example.* CFC is acquired in a CAA with a basis difference of $120 in all of its assets, recovered over 15 years ($8 ABD per year). CFC has $20 of foreign taxable income and pays $6 of foreign tax. Under the general formula for cost-recovery amounts, CFC's disqualified tax amount each year would be $2.40, which is the result of $6 multiplied by the $8 cost-recovery ABD / $20 of foreign income.

Assume that in the same year as the CAA, while the basis difference in CFC's assets was still $120, CFC sold all of its assets and recognized a foreign taxable gain of $240, subject to $72 of foreign tax. Assume for simplicity that this was CFC's only income and only cost recovery amount during the taxable year. As a result of this disposition of CFC's assets, the entire basis difference would be taken into account under §901(m)(3). The disqualified tax amount for the year would $36, or $72 of foreign taxes multiplied by the $120 disposition amount ABD / $240 of foreign taxable income.

Following through on Notice 2014-44 and Notice 2014-45, the temporary regulations define a ''disposition'' as an event that results in recognition of taxable gain or loss for U.S. purposes, foreign purposes, or both.[40] Further, the ''disposition amount'' taken into account to recover the basis difference is generally limited to the taxable gain recognized for foreign purposes on the disposition.[41] Thus, if a disposition, as in the simple example above, were not fully taxable for foreign purposes, the ABD and future disallowance amount would continue to apply. The transferee of assets in a disposition where the ABD is not fully recovered is treated as a successor, that continues to be subject to §901(m).[42]

The proposed regulations would elaborate on the calculation of the disposition amount, and also provide rules for successors to an ABD carryover amount. Under the latter rules, the transferee is treated as a successor to an ABD carryover amount if the

[36] *Id.*

[37] Prop. Reg. §1.901(m)-3(c)(2)(ii)(A).

[38] Prop. Reg. §1.901(m)-3(c)(2)(ii)(B).

[39] Prop. Reg. §1.901(m)-3(c)(3) *Ex.*

[40] Reg. §1.901(m)-1T(a)(10).

[41] Reg. §1.901(m)-5T(c)(2).

[42] Reg. §1.901(m)-6T(b).

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transferee is a party to a §381 transaction or the transferor otherwise transfers substantially all of its assets to the transferee.[43] Additionally, if the foreign payor transfers some but not all of its assets with a principal purpose of avoiding §901(m), a pro rata portion of the ABD carryover amount (by fair market value) will follow the transferred assets.[44] Where applicable, these rules would prevent a CFC from transferring income-producing assets to another entity to shed the burden of an ABD carryover amount.

> *Example.* CFC in Country X has RFAs with an ABD that has been amortized over time. However, due to Country X NOLs and/or lack of profitability on its current operations, the Country X CFC has not paid any Country X tax and has accumulated a $100 ABD carryover amount. Shortly before its assets begin to generate profit, Country X CFC contributes its RFAs to a new Country X CFC subsidiary that has no ABD carryover amount. However, under either the rule relating to the transfer of substantially all of the Country X CFC's assets, or potentially the anti-abuse rule, this transfer could cause the new CFC subsidiary to inherit some or all of the $100 ABD carryover amount.

DE MINIMIS RULES

Lastly, the proposed regulations offer two de minimis exceptions from §901(m). However, the level of ''de minimis'' as defined in the proposed regulations, at least for the overall exemption, is likely to be too low to provide much relief in the real world. Also, the de minimis rules themselves are subject to significant complexity.

The proposed regulations offer two separate de minimis rules: an overall de minimis rule and an asset class-based exemption that follows the classes of assets under §1060. To the extent either exception applies, the basis difference for the RFAs is disregarded for §901(m) purposes. Under the overall de minimis exception, the total basis difference with respect to the CAA is disregarded if it is less than the *greater of* (a) $10 million or (b) 10% of the U.S. tax basis in the RFAs immediately after the CAA. This exception sets a relatively low bar, especially when the special rule for ''aggregated CAA transactions,'' discussed below, is taken into account.

Under the asset-class based exemption, a basis difference with respect to RFAs in a particular asset class under §1060 is disregarded if the total basis differences of all RFAs in that class are less than the *greater of* (a) $2 million or (b) 10% of the U.S. tax basis in that class of assets after the acquisition. As illustrated by Prop. Reg. §1.901(m)-7(f) *Ex.* 2, the intent of the asset class-based exemption is to alleviate the administrative burden of tracking §901(m) with respect to inventory or property, plant and equipment without significant appreciation. Whether there is significant appreciation in an asset class, of course, will depend on the allocation of purchase price.

The exceptions above are further qualified in the case of a transaction in which one or more CAAs occur as part of the same plan or related transaction (''aggregated CAA transaction''). In this case, the de minimis rules must be satisfied both on a separate basis for each individual CAA and on an overall basis for all CAAs that occur as part of the aggregated CAA transaction. Apparently, this aggregation rule applies even if the RFAs are located in multiple countries.[45]

As illustrated by Example 1 in Prop. Reg. §1.901(m)-7(f), the need to test de minimis on a separate CAA and aggregated CAA basis can lead to bizarre results. In the example, two CFCs located in Country F have the following basis differences, all of which are in the same §1060 asset class (IP):

[43] Prop. Reg. §1.901(m)-6(c)(1), §1.901(m)-6(c)(2).

[44] Prop. Reg. §1.901(m)-6(c)(3).

[45] Note that the only example illustrates two RFA owners in the same country and thus doesn't answer this basic question.

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	U.S. Basis Before CAA	U.S. Basis After CAA	Basis Difference
CFC1	$48m	$60m	$12m
CFC2	$100m	$96m	<$4>m
Total	$148m	$156m	$8 m

CFC1 and CFC2 are acquired as part of the same aggregated CAA transaction. Therefore, in determining whether the overall de minimis exception applies, CFC1 and CFC2 must be tested on both a separate basis and an aggregate basis. On an aggregate basis, the two CAAs have less than a $10m basis difference (and also less than 10% of post-U.S. tax basis of $156m), and therefore, the de minimis test is met. However, on a separate entity basis, CFC1 fails the test, because its positive basis difference of $12m exceeds the greater of $10m and 10% of its U.S. tax basis of $60m. With respect to CFC2, however, the basis difference of negative $4m is disregarded as de minimis because it is less than $10m. Under this rule, any separate RFA owner with an overall built-in loss would seem to have that built-in loss eliminated from a §901(m) perspective. By contrast, if CFC1's and CFC2's assets had been consolidated into a single entity, the built-in loss would be taken into account for purposes of determining whether there is an aggregate basis difference, and also would survive the application of the de minimis rules to the transaction. In a trap for the unwary, it appears that the de minimis rule can function effectively as a loss disallowance rule for §901(m) purposes.

The proposed regulations also would further restrict the application of the de minimis rules to CAAs involving related parties. In such cases, the de minimis thresholds are significantly lower ($5m and 5% overall and $1m for an individual class exemption). In addition, an anti-abuse rule may also apply in the related-party context where transactions are structured to qualify for the de minimis exceptions.

MISCELLANEOUS RULES

The proposed regulations also state that §901(m) applies to pre-1987 foreign income taxes of a §902 corporation.[46] Thus, a taxpayer that acquires a foreign target without a §338 election will potentially be faced with §901(m) disallowance with respect to the foreign target's pre-acquisition layers of E&P and taxes. In the context, the new CAA categories for asset transfers resulting in a basis difference (without any U.S. tax elections) would lead to an increased chance of those prior layers being affected by §901(m).

Lastly, the proposed regulations include an anti-abuse rule to prevent ''trafficking'' in RFAs with a negative basis difference (so-called ''built-in-loss RFAs'').[47] This rule would apply where, with a principal purpose of avoiding §901(m), assets were transferred to cause gain RFAs and built-in-loss RFAs to be combined in a single payor, apparently by enabling the built-in-loss RFAs to reduce the payor's ABD and disqualified tax amount. However, as illustrated by Prop. Reg. §1.901(m)-3(b)(3) *Ex.* 2, a positive basis difference and a negative basis difference in the same entity is netted for purposes of the disqualified tax amount calculation. In light of this principle, it is not clear why it is abusive to take steps to combine assets with positive basis differences and negative basis differences within a given country.

CONCLUSION

In short, the proposed regulations provide long-awaited and comprehensive guidance on a statute that calls for detailed calculations. The one possibly helpful taxpayer-favorable change in the proposed regulations is the foreign-basis election, and particularly the measurement of the basis difference using foreign basis after the CAA and taking into account step-ups in the CAA. In this respect, the proposed regulations provide a needed technical patch to an ill-drafted statute. However, the proposed regulations contain several new rules that taxpayers are likely to find adverse, such as the expanded CAA categories and the ABD carryover amount. The high degree of complexity of the rules in certain areas leaves a lot to be desired. With respect to deciding on early adoption, on balance for most taxpayers, the bitter will probably taste stronger than the sweet.

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[46] Prop. Reg. §1.901(m)-8(a).

[47] Prop. Reg. §1.901(m)-8(b).

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