Foreign tax credit guidance under section 901(m)

Notice 2014-44

SECTION 1. OVERVIEW

This notice announces that the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) will issue regulations addressing the application of section 901(m) of the Internal Revenue Code (Code) to dispositions of assets following covered asset acquisitions (CAAs) and to CAAs described in section 901(m)(2)(C) (regarding section 754 elections).

SECTION 2. BACKGROUND

Section 901(m)(1) provides that, in the case of a CAA, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to relevant foreign assets (RFAs) will not be taken into account in determining the foreign tax credit allowed under section 901(a), and in the case of foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)) will not be taken into account for purposes of section 902 or 960. Instead, the disqualified portion of any foreign income tax is allowed as a deduction.

Section 901(m)(2) provides that a CAA is: (1) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (Section 338 CAA); (2) any transaction that is treated as an acquisition of assets for U.S. income tax purposes and as the acquisition of stock of a corporation (or is disregarded) for purposes of a foreign income tax; (3) any acquisition of an interest in a partnership that has an

election in effect under section 754 (Section 743(b) CAA); and (4) to the extent provided by the Secretary, any other similar transaction.

Section 901(m)(4) provides that the term RFA means, with respect to a CAA, any asset (including goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain, or loss attributable to such asset is taken into account in determining the foreign income tax referenced in section 901(m)(1).

Section 901(m)(3)(A) provides that the term "disqualified portion" means, with respect to any CAA, for any taxable year, the ratio (expressed as a percentage) of: (1) the aggregate basis differences (but not below zero) allocable to such taxable year with respect to all RFAs; divided by (2) the income on which the foreign income tax referenced in section 901(m)(1) is determined. If the taxpayer fails to substantiate the income on which the foreign income tax is determined to the satisfaction of the Secretary, such income will be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to the taxpayer's income in the relevant jurisdiction.

Section 901(m)(3)(C)(i) provides that basis difference means, with respect to any RFA, the excess of (1) the adjusted basis of such asset immediately after the CAA, over (2) the adjusted basis of such asset immediately before the CAA. The basis difference can be either a positive or a negative number.

Section 901(m)(3)(B)(i) provides the general rule that the basis difference with respect to any RFA will be allocated to taxable years using the applicable cost recovery method for U.S. income tax purposes.

Section 901(m)(3)(B)(ii) provides that, except as otherwise provided by the Secretary, if there is a disposition of any RFA, the basis difference allocated to the taxable year of the disposition will be the excess of the basis difference of such asset over the aggregate basis difference of such asset that has been allocated to all prior taxable years (Unallocated Basis Difference). No basis difference with respect to such asset will be allocated to any taxable year thereafter.

Regarding the treatment of dispositions of RFAs, the Staff of the Joint Committee on Taxation's technical explanation of section 901(m) provides:

> If there is a disposition of any relevant foreign asset before its cost has been entirely recovered or of any relevant foreign asset that is not eligible for cost recovery (e.g., land), the basis difference allocated to the taxable year of the disposition is the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset that has been allocated under this provision to all prior taxable years. Thus, any remaining basis difference is captured in the year of the sale, and there is no remaining basis difference to be allocated to any subsequent tax years. However, it is 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.

Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010, at 15 (August 10, 2010) (emphasis added).

Section 901(m)(7) provides that the Secretary may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 901(m), including to exempt from its application certain CAAs and RFAs with respect to which the basis difference is de minimis.

SECTION 3. CONCERNS WITH STATUTORY DISPOSITION RULE

Applying the statutory disposition rule under section 901(m)(3)(B)(ii) to the disposition of an RFA is appropriate in fact patterns in which the gain or loss from the disposition is fully recognized for purposes of both U.S. income tax and a foreign income tax. However, in certain cases, including cases in which the gain or loss from the disposition is recognized for purposes of U.S. income tax but not for purposes of a foreign income tax, or, as described in the next paragraph, cases in which no gain or loss is recognized for purposes of U.S. income tax or the foreign income tax, it may not be the appropriate time for all, or any, of the Unallocated Basis Difference to be taken into account. Furthermore, section 901(m) should continue to apply to the remaining Unallocated Basis Difference.

In this regard, the IRS and the Treasury Department 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). For example, assume USP, a domestic corporation, wholly owns FSub, a foreign corporation, and FSub acquires 100 percent 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 § 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. See § 1.338-3(c)(1) and § 301.7701-3(g)(1)(iii) and (g)(3)(ii). On these facts, no gain or loss is recognized on the deemed liquidation by either FT or FSub pursuant to sections 332 and 337.

The 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 taxable 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 taxable year. This claim is made notwithstanding that (i) the disparity in the basis in the assets of FT for purposes of U.S. income tax and the foreign income tax that arose as a result of the Section 338 CAA continues to exist after the deemed liquidation, and (ii) 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. Although the deemed liquidation of FT is also a CAA, the basis difference that arises with respect to this subsequent CAA generally would be minimal. Taxpayers have engaged in other variations of this transaction, each of which raises significant policy concerns.

Accordingly, under the specific authority granted to the Secretary under sections 901(m)(3)(B)(ii) and 901(m)(7), the IRS and the Treasury Department will issue the regulations described in section 4 of this notice.

SECTION 4. REGULATIONS TO BE ISSUED

.01 Application of Section 901(m) to a Disposition of an RFA

For purposes of section 901(m), a disposition means an event (for example, a sale, abandonment, or mark-to-market event) that results in gain or loss being recognized with respect to an RFA for purposes of U.S. income tax or a foreign income tax, or both. For example, in transactions such as those described in section 3 of this notice, the tax-free deemed liquidation arising upon FT's entity classification election does not result in a disposition of an asset for purposes of section 901(m). See section 4.04, Example 1.

The portion of a basis difference with respect to an RFA that is taken into account for a taxable year as a result of a disposition (Disposition Amount) will be determined pursuant to either of two rules. First, if a disposition is fully taxable (that is, results in all gain or loss, if any, being recognized with respect to the RFA) for purposes of both U.S. income tax and a foreign income tax, the Disposition Amount is equal to the Unallocated Basis Difference. This is because there generally will no longer be a disparity in the basis of the RFA for purposes of U.S. income tax and the foreign income tax (U.S. Basis and Foreign Basis, respectively).

Second, if a disposition is not fully taxable for purposes of both U.S. income tax and a foreign income tax, generally there will continue to be a disparity in the U.S. Basis and the Foreign Basis following the disposition, and it is appropriate for the RFA to continue to be subject to section 901(m). To the extent that the disparity in the U.S. Basis and the Foreign Basis is reduced as a result of the disposition, however, a portion of the Unallocated Basis Difference (or in certain cases, all of the Unallocated Basis Difference) should be taken into account. Whether the disposition reduces the basis disparity will depend on whether the basis difference is positive or negative and the

jurisdiction in which gain or loss is recognized.

In the case of a positive basis difference, a reduction in basis disparity generally will occur upon a disposition of an RFA if (i) gain is recognized for purposes of a foreign income tax (Foreign Disposition Gain), which generally results in an increase in the Foreign Basis of the RFA, or (ii) loss is recognized for U.S. income tax purposes (U.S. Disposition Loss), which generally results in a decrease in the U.S. Basis of the RFA. Accordingly, if the RFA has a positive basis difference, the Disposition Amount equals the lesser of:

(i) any Foreign Disposition Gain plus any U.S. Disposition Loss (solely for this purpose, expressed as a positive amount), or

(ii) the Unallocated Basis Difference.

In the case of a negative basis difference, a reduction in basis disparity generally will occur upon a disposition of an RFA if (i) loss is recognized for purposes of a foreign income tax (Foreign Disposition Loss), which generally results in a decrease in the Foreign Basis of the RFA, or (ii) gain is recognized for U.S. income tax purposes (U.S. Disposition Gain), which generally results in an increase in the U.S. Basis of the RFA. Accordingly, if the RFA has a negative basis difference, the Disposition Amount equals the greater of the following amounts:

(i) any Foreign Disposition Loss plus any U.S. Disposition Gain (solely for this purpose, expressed as a negative amount), or

(ii) the Unallocated Basis Difference.

To the extent the entire Unallocated Basis Difference is not taken into account as a Disposition Amount, section 901(m) continues to apply to the remaining Unallocated

Basis Difference. See section 4.03 of this notice.

.02 Special Rules for a Section 743(b) CAA

If an RFA is subject to a Section 743(b) CAA, the basis difference generally is the resulting basis adjustment under section 743(b) that is allocated to the RFA under the rules of section 755.

If an RFA was subject to a Section 743(b) CAA and subsequently there is a disposition of the RFA, consistent with the computation of basis difference in a Section 743(b) CAA, the computation of the Disposition Amount only takes into account the amount of gains and losses that are attributable to the partnership interest that was transferred in the Section 743(b) CAA. Accordingly, for purposes of determining the Disposition Amount, Foreign Disposition Gain or Foreign Disposition Loss means the amount of gain or loss recognized for purposes of a foreign income tax on the disposition of the RFA that is allocable to the partnership interest that was transferred in the Section 743(b) CAA. In addition, U.S. Disposition Gain or U.S. Disposition Loss means the amount of gain or loss recognized for U.S. income tax purposes on the disposition of the RFA that is allocable to the partnership interest that was transferred in the Section 743(b) CAA, taking into account the basis adjustment under section 743(b) that was allocated to the RFA under section 755.

.03 Continuing Application of Section 901(m) to Remaining Basis Difference

Section 901(m) continues to apply to an RFA until the entire basis difference in the RFA has been taken into account under section 901(m)(3)(B)(i) using the applicable cost recovery method for U.S. income tax purposes or as a Disposition Amount (or both). Thus, even if there is a change in the ownership of an RFA, for example, by

reason of a transaction that is a disposition only for U.S. income tax purposes, section 901(m) continues to apply to the RFA until any remaining Unallocated Basis Difference in the RFA has been taken into account. The IRS and the Treasury Department are continuing to consider whether and to what extent section 901(m) should 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.

If an RFA is subject to multiple Section 743(b) CAAs (Prior Section 743(b) CAA and Subsequent Section 743(b) CAA) and the same partnership interest is acquired in both the Prior Section 743(b) CAA and the Subsequent Section 743(b) CAA, the RFA will be treated as having no Unallocated Basis Difference with respect to the Prior Section 743(b) CAA for purposes of applying section 901(m) to the Subsequent Section 743(b) CAA if the basis difference for the Subsequent Section 743(b) CAA is determined independently from the Prior Section 743(b) CAA. In this regard, see generally § 1.743-1(f) and proposed § 1.743-1(f)(2). If the Subsequent Section 743(b) CAA results from the acquisition of only a portion of the partnership interest acquired in the Prior Section 743(b) CAA, then the transferor will be required to equitably apportion the Unallocated Basis Difference attributable to the Prior Section 743(b) CAA with respect to the RFA between the portion retained by the transferor and the portion transferred. With respect to the portion transferred, the RFA will be treated as having no Unallocated Basis Difference with respect to the Prior Section 743(b) CAA for purposes of applying section 901(m) to the Subsequent Section 743(b) CAA if the basis difference for the Subsequent Section 743(b) CAA is determined independently from the Prior Section 743(b) CAA.

.04 Examples

Example 1. (i) Facts. USP, a domestic corporation, wholly owns CFC, a foreign corporation organized under the laws of Country A. FT is an unrelated foreign corporation organized under the laws of Country A and subject to Country A income tax. FT owns one asset (Asset), a parcel of land. On January 1, Year 1, CFC acquires all the stock of FT in exchange for 300u (Acquisition) in a qualified stock purchase for which an election under section 338(g) is made. The Acquisition is treated as an asset acquisition for U.S. income tax purposes and as a stock acquisition for Country A income tax purposes. Immediately before the Acquisition, Asset had a U.S. Basis and Foreign Basis of 100u. Effective on February 1, Year 1, FT elects to be disregarded as an entity separate from its owner pursuant to § 301.7701-3. As a result of the election, FT is deemed, solely for U.S. tax purposes, to distribute Asset to CFC in liquidation (Deemed Liquidation) immediately before the closing of the day before the election is effective pursuant to § 301.7701-3(g)(1)(iii) and -3(g)(3)(ii). No gain or loss is recognized on the Deemed Liquidation for purposes of either U.S. income tax or Country A income tax.

(ii) Analysis. The Acquisition is a Section 338 CAA because section 338(a) applies to the qualified stock purchase of FT stock with respect to which the section 338(g) election is made. Immediately after the Acquisition, Asset is an RFA owned by CFC with a basis difference of 200u (300u – 100u). Because the Deemed Liquidation does not result in gain or loss being recognized with respect to Asset for purposes of U.S. income tax or Country A income tax, there is no disposition of Asset for purposes of section 901(m). Accordingly no basis difference with respect to Asset is taken into account by FT as a result of the Deemed Liquidation. Furthermore, section 901(m) will continue to apply to the basis difference with respect to Asset, as held by CFC for U.S. income tax purposes, until the entire 200u basis difference has been taken into account under section 901(m)(3)(B).

Example 2. (i) Facts. The facts are the same as Example 1, except that FT does not elect to be disregarded as an entity separate from its owner. Instead, on March 1, Year 1, FT transfers Asset (worth 300u and U.S. Basis of 300u) to FC (Transfer), an unrelated controlled foreign corporation organized under the laws of Country A, in exchange for stock of FC worth 250u and 50u of cash. The Transfer results in gain of 50u recognized for Country A income tax purposes. Although the Transfer is a taxable transaction for U.S. income tax purposes, no gain or loss is recognized for U.S. income tax purposes because the amount realized and the U.S. Basis are the same amount.

(ii) Analysis. Because the Transfer results in gain being recognized by FT with respect to Asset for Country A income tax purposes, there is a disposition of Asset for purposes of section 901(m). Accordingly, FT takes into account the portion of the basis difference with respect to Asset equal to the Disposition Amount of 50u (the lesser of the Foreign Disposition Gain of 50u or the Unallocated Basis Difference of 200u). Section 901(m) will continue to apply to Asset, as held by FC, until the remaining 150u basis difference (200u – 50u) has been taken into account under section 901(m)(3)(B).

SECTION 5. EFFECTIVE DATE

Except as provided in this section 5, the regulations described in this notice will apply to dispositions occurring on or after July 21, 2014. The regulations described in the first paragraph of section 4.02 and second paragraph of section 4.03 of this notice 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. The regulations described in the first two sentences of the first paragraph of section 4.03 of this notice 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. No inference is intended as to the treatment of transactions such as those described in section 3 of this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines.

SECTION 6. DRAFTING INFORMATION

The principal authors of this notice are Joseph W. Vetting and Jeffrey L. Parry, of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice, contact Mr. Parry at (202) 317-6936 (not a toll-free call).