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MEMORANDUM FOR STAN BEESLEY
CP:IN:OO:LONDON
REVENUE SERVICE REPRESENTATIVE

FROM: Barbara A. Felker, Chief, CC:INTL:Br3 BAF/RR

SUBJECT: Alternative Minimum Tax Foreign Tax Credit Computation

This memorandum responds to your request of November 9, 1998, for a reply to John Havard's faxed inquiry dated October 30, 1998, regarding the calculation of the alternative minimum tax foreign tax credit for 1997. Mr. Havard requested guidance on whether section 904(b)(2)(B) applies in computing the allowable alternative minimum tax (AMT) foreign tax credit. He stated that the adjustment made by line 17 of Form 1116 (which carries out section 904(b)(2)(B)(ii)'s adjustment of capital gains in the denominator of the 904(a) foreign tax credit limitation fraction) has no analogue on the "AMT version" of Form 1116 utilized by Fast-Tax and another software vendor. Mr. Havard expressed concern that section 59(a)(1)(B)'s cross-reference to section 904 might not contain sufficient authority, or provide sufficient mechanical guidance, to make the adjustment.

As discussed below, in our view section 59(a) requires the section 904(b) adjustments to be made in computing the AMT foreign tax credit limitation. We believe that the instructions to Forms 6251 and 1116 can and should be interpreted in this manner. We plan to recommend that the instructions to the 1999 version of Form 6251 be clarified on this point.

A. <u>The instructions for Form 6251 and Form 1116 can be read together to require the adjustment</u>

The 1997 instructions for Form 6251 (the form for calculating the AMT for individuals) state that taxpayers should "enter the AMTI from Form 6251, line 21, on

Form 1116, line 17." [1] This language does not explicitly require any adjustment for capital gains. However, line 17 of the 1997 Form 1116 contains a cautionary note, which states: "If you figured your tax using the special rates on capital gains, see page 9 of the instructions." Page 9 of Form 1116's 1997 instructions, in turn, describes (and contains a worksheet to carry out) the section 904(b) adjustment to the foreign tax credit limitation fraction's denominator. Therefore, we think the better reading is that the Form 6251 instructions' reference to Form 1116's line 17 includes a reference to line 17's cautionary note and thus to the instructions regarding the adjustment for capital gains. Similarly, the worksheet for line 17 (in the Form 1116 instructions) requires taxpayers to enter amounts from certain lines of Schedule D. To the extent capital gains used in the AMT calculation differ from those reported on Schedule D, the AMT capital gains should be used for purposes of determining the AMT foreign tax credit. We plan to recommend that the instructions to the 1999 version of Form 6251 be clarified on these points.

B. <u>The statute requires the section 904(b) adjustments in the AMT context</u>

Section 59's description of the AMT foreign tax credit appears to require the section 904(b) adjustments. Section 59(a)(1) provides that the AMT foreign tax credit equals the foreign tax credit which would be determined under section 27(a) (which refers back to section 901) if 1) for purposes of section 904, the credit were taken against the pre-credit tentative minimum tax, 2) "section 904 were applied on the basis of alternative minimum taxable income instead of taxable income," and 3) high-taxed income (for purposes of section 904(d)(2)) were determined using rates specified in section 55(b)(1) rather than section 1 or 11. Thus, section 901 and the other sections necessary to calculate the section 901 foreign tax credit (including section 904) apply in the AMT foreign tax credit context except as modified by section 59 or other provisions. Neither section 59 nor any other provision of which we are aware prevents or modifies the section 904(b) capital gain and loss adjustments in the AMT foreign tax credit context. For example, section 59(a)(1)'s second requirement, stating that section 904 shall be applied on the basis of AMT taxable income, does not preclude the otherwise applicable section 904(b)(2)(B) adjustments for capital gain rate differentials.

In addition, no major mechanical difficulty arises in applying the section 904(b) adjustments to the AMT foreign tax credit. The terms used in section 904(b) can be applied to the AMT foreign tax credit, subject to section 59(a)'s requirement that AMT taxable income be substituted for taxable income. Section 904(b)(2)(B) (adjusting the foreign tax credit fraction based on capital gains rates) applies if

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[1] The 1998 instructions for Form 6251 contain the same language.

there is a "capital gain rate differential" for the taxable year. According to section 904(b)(3)(D), a capital gain rate differential exists if section 1(h) applies to a non-corporate taxpayer or, for a corporate taxpayer, if any rate of tax imposed by section 11, 511, or 831(a) or (b) exceeds the alternative rate of tax under section 1201 (determined with some adjustments). Nothing in section 59(a)'s cross reference to section 904 prevents or alters this determination, which for an individual taxpayer is currently made by reference to section 1(h).

Similarly, there is no bar to carrying out the specific adjustments of section 904(b)(2)(B)(i), (ii), and (iii) in the AMT foreign tax credit context. For example, section 904(b)(2)(B)(i) provides that if there is a capital gain rate differential, then for purposes of section 904 "taxable income from sources outside the United States shall include gain from the sale or exchange of capital assets only in an amount equal to foreign source capital gain net income reduced by the rate differential portion of foreign source net capital gain." This provision adjusts capital gains in the numerator of the section 904(a) fraction. In calculating the AMT foreign tax credit, AMT taxable income would be substituted for taxable income. In addition, foreign source capital gain net income and foreign source net capital gain would be calculated by taking into account only items that are taken into account in determining AMT taxable income.

Section 904(b)(3)(E) defines the rate differential portion of various capital gain amounts.[2] The rate differential portion of each amount equals the same proportion of that amount as 1) the excess of highest applicable rate under section 1 or section 11 (for non-corporate and corporate taxpayers, respectively) over the rate under section 1(h) or section 1201(a), respectively, bears to 2) the highest applicable rate under section 1 or section 11, respectively. Id. There is no mechanical reason why this calculation cannot be performed in the AMT foreign tax credit context, because the "rate differential portion" of an amount is determined by merely comparing tax rates to each other.

Under the same reasoning, the adjustments under sections 904(b)(2)(B)(ii) (which adjusts capital gains in the denominator of the section 904(a) fraction) and 904(b)(2)(B)(iii) (which adjusts capital losses in the fraction's numerator) would also apply in determining the AMT foreign tax credit.

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[2] Each of these amounts would be determined by taking into account only items taken into account in determining AMT taxable income.

C. Conclusion

In summary, we believe that under the Code, the section 904(b) adjustments for capital gains and losses apply to the AMT foreign tax credit. Although Mr. Havard's memorandum referred only to the section 904(b)(2)(B)(ii) adjustment to the foreign tax credit limitation fraction's denominator, the other section 904(b)(2)(B) adjustments must also be made, as applicable. In other words, section 59(a) also incorporates section 904(b)'s adjustment of the numerator of the AMT foreign tax credit limitation fraction, and its adjustment to capital losses in the denominator. In addition, Mr. Havard's memorandum stresses the applicability of section 59(a)(1) in 1997. The section 59(a)(4) election to use foreign source regular taxable income as the numerator of the section 904 AMT foreign tax credit limitation fraction will be available after 1997. However, the denominator adjustments required by section 904(b) will continue to apply for AMT purposes, and the numerator adjustments will still be required for taxpayers who choose not to make the section 59(a)(4) election.

We will recommend that the Forms division clarify the instructions for computing the AMT foreign tax credit on the 1999 version of Form 6251. We will also consider whether the capital gains adjustment worksheets in Form 1116's instructions should be modified in the AMT context. We appreciate your forwarding Mr. Havard's memorandum and would welcome further comments on this subject.

If you have further questions, please contact Rebecca Rosenberg at (202) 622-3850.

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