



International Tax

United States Tax Alert

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Internal Revenue Service Issues Guidance under Section 901(m) on Dispositions Following Covered Asset Acquisitions

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On July 21, 2014, the Internal Revenue Service (IRS) released Notice 2014-44 (the Notice), which announced that the IRS and Department of the Treasury will issue regulations addressing the application of section 901(m) to the disposition of assets following a covered asset acquisition (CAA). The regulations described in the Notice will apply to transactions occurring on or after July 21, 2014.

Background

Section 901(m) provides that, in the case of a CAA, the “disqualified portion” of any foreign income tax paid is permanently disallowed as a tax credit under section 901(a). Assets that are subject to a CAA are referred to as relevant foreign assets (RFAs). The disqualified portion of foreign income tax paid for a tax year is calculated by multiplying the foreign taxes imposed on income attributable to RFAs by a percentage of: (1) the aggregate “basis differences” allocated for the year with respect to all RFAs over (2) the income on which the foreign income tax is determined. Basis differences for RFAs are calculated by subtracting the adjusted basis of an RFA before a CAA from the adjusted basis of an RFA immediately after a CAA.

In general, the aggregate basis differences attributable to RFAs are allocated to taxable years based on the applicable cost recovery method of the taxpayer. However, where there is a “disposition” of RFAs, section 901(m)(3)(B)(ii) provides that any remaining (or “unallocated”) basis difference is taken into account in the year of the disposition, and no basis difference with respect to the RFA will be allocated to any taxable year thereafter (the Statutory Disposition Rule). Although not reflected in the statute, the Staff of the Joint Committee on Taxation’s Technical Explanation of 901(m) indicates that the Statutory Disposition Rule is meant to apply where the disposition is taxable in the relevant foreign jurisdiction.¹

¹ 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* (JCX-46-10), August 10, 2010.

Transactions Addressed by the Notice

The Notice addresses the IRS' concern that the Statutory Disposition Rule is being applied by some taxpayers to dispositions in which foreign income tax is not imposed in the relevant foreign jurisdiction. Even though all remaining basis differences are allocated to the year of disposition, the disqualified portion of foreign income tax in the year the Statutory Disposition Rule is applied may be less than what the disqualified portion of foreign income tax paid would have been if the RFAs were not disposed of, and the basis difference had been allocated to tax years based on the depreciation method of the taxpayer.

This concern is illustrated by an example in the Notice where a domestic corporation (USP) wholly owns a foreign corporation (FSub), which purchases 100 percent of a foreign corporation (FT). An election is made under section 338(g) with respect to FT, such that the acquisition is a CAA. The RFAs are those owned by FT. Shortly after the acquisition, FT files a check-the-box election to be disregarded as an entity separate from its owner, resulting in a tax-free liquidation under section 332. No gain or loss is recognized with respect to the RFAs for U.S. or foreign income tax purposes. Nevertheless, some taxpayers take the position that the transaction constitutes a disposition of RFAs, and the Statutory Disposition Rule provides that no basis differences will be allocated to any year following the liquidation.

Regulations to be Issued

Definition of “Disposition”

Regulations to be issued under the Notice will provide that, for purposes of section 901(m), a disposition is a transaction which results in the recognition of gain or loss with respect to an RFA for either U.S. income tax purposes, foreign income tax purposes, or both. Therefore, transactions which are tax-free for U.S. and foreign income tax purposes will not constitute a “disposition” under section 901(m).

Application of the Statutory Disposition Rule

In the case where a disposition occurs, the unallocated basis difference with respect to an RFA which is taken into account in the year of a disposition is determined based on one of two rules:

1. In the case where a disposition is fully taxable for purposes of both U.S. and foreign income tax, the Statutory Disposition Rule is applied as described in section 901(m)(3)(B)(ii). That is, any unallocated basis difference is taken into account in the year of the disposition, and not in any year thereafter.
2. If the disposition is *not* fully taxable for purposes of both U.S. and foreign income tax purposes, but there is a reduction in the total disparity in the U.S. basis and foreign basis of a RFA, then the disposition rule will apply with respect to the total reduction in basis disparity. An RFA can have either a positive basis difference or a negative basis difference. Transactions that result in a decrease in a positive basis difference or an increase in a negative basis difference are taken into account to determine the total basis difference allocated to the year of a disposition.

Carryover of Remaining Basis Difference

Section 901(m) will continue to apply to RFAs that were previously acquired in a CAA if there is any unallocated basis difference associated with the assets, even if there is a change in ownership. Therefore, if a taxpayer acquires RFAs in a transaction which does not constitute a disposition under 901(m), or in a disposition where basis differences are not fully allocated, the acquiring taxpayer must calculate its disqualified portion of foreign income tax under section 901(m)(1) that is due to a prior CAA of the RFAs.

Special Rules for CAAs and Partnerships

The Notice provides special rules for determining the amount of a disposition of RFAs by a partnership, focusing solely on the amount of gain or loss that is allocable to the partnership interest that was transferred and which gave rise to the section 743 basis adjustments in RFAs.

Guidance is also provided for determining the amount of unallocated basis difference in the case of multiple acquisitions of the same interest in a partnership that has an election in effect under section 754.

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