Report No. 1375

New York State Bar Association

Tax Section

Report on the Temporary and Proposed Regulations under Section 901(m)

June 21, 2017

#52557455v4

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Report on the Temporary and Proposed Regulations under Section 901(m)

I. INTRODUCTION

This report[1] comments on proposed[2] and temporary[3] regulations under section 901(m) of the Internal Revenue Code of 1986, as amended[4] (the "Temporary Regulations" and the "Proposed Regulations," respectively, and together, the "Regulations").[5] Section 901(m) generally disallows U.S. foreign tax credits for foreign taxes attributable to income recognized for foreign but not U.S. income tax purposes as a result of certain defined asset acquisitions that cause a tax basis "step up" for U.S. but not for foreign tax purposes.

The Regulations, pursuant to authority granted under section 901(m), describe certain transactions that will result in the application of section 901(m) in addition to those specified in the statute. The Regulations adopt successor rules that address how the credit disallowance will work when assets subject to section 901(m) are transferred. The Regulations also provide complex and elaborate technical rules intended to ensure that an appropriate amount of foreign

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[1] The principal authors of this report are Andrew Walker and Eschi Rahimi-Laridjani, with substantial assistance from Kimberly Blanchard, Andrew Braiterman, Peter Connors, Michael Farber, David Hardy, Stow Lovejoy, Michael Schler, Karen Sowell and Eric Wang. The assistance of David Hanno is gratefully acknowledged.

[2] Notice of Proposed Rulemaking, REG-129128-14, 81 Fed. Reg. 88,562 (Dec. 7, 2016).

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

[4] Hereinafter referred to as the "Code." All section references are to the Code or to Treasury regulations issued thereunder.

[5] We have previously commented on section 901(m) in New York Bar Association Tax Section, Report No. 1231, *Section 901(m): Covered Asset Acquisitions* (Jan. 28, 2011) (the "Prior 901(m) Report"), available at http://www.nysba.org.

income tax is disallowed as a credit to the appropriate taxpayer when, as a result of inconsistent U.S. and foreign treatment of entities, the legal person treated as incurring the foreign tax liability and/or owning the assets or income in question may differ for U.S. and foreign purposes. Finally, the Regulations introduce a "foreign basis election" and establish certain *de minimis* exceptions from the section 901(m) regime.

Part II of this report summarizes our recommendations. Part III describes the history and statutory background to the Regulations. Part IV summarizes certain guidance released by the Treasury and the Internal Revenue Service ("IRS") and the Regulations, with an emphasis on the provisions to which our recommendations relate. Part V discusses the reasons for our recommendations.

II. SUMMARY OF RECOMMENDATIONS

The following is a summary of our recommendations relating to the Proposed Regulations.

1. We recommend that the new type of covered asset acquisition, which includes any asset acquisition for U.S. and foreign purposes that results in a U.S.-foreign basis disparity, be replaced with one or more specific better-defined transactions, including the transaction set forth in Proposed Treasury Regulations section 1.901(m)-2(e), Example (2). We also recommend adding an anti-abuse rule targeting transactions that are structured with a principal purpose of avoiding application of the Proposed Treasury regulations section 1.901(m)-2(b)(1)-(6).
2. We recommend eliminating the 50% reduction of the *de minimis* thresholds for related party transactions and increasing the thresholds for the cumulative basis difference exemption and the relevant foreign asset class exemption.

3. We recommend that the foreign basis election be made available to taxpayers who consistently apply the Proposed Regulations to covered asset acquisitions that have occurred since 2011 with respect to all tax years that remain open.

4. We recommend adding a specific priority rule to the effect that where a transaction is both a covered asset acquisition and a "foreign tax credit splitting event," the rules of section 901(m) will apply first.

5. We recommend that the Treasury and the IRS consider whether it would be appropriate to apply the principles of section 704(c) to situations in which "relevant foreign assets" (from a prior covered asset acquisition) are contributed to a new partnership.

III. BACKGROUND

The purpose of the U.S. foreign tax credit regime is to mitigate the double taxation that would result if the foreign-source income of a U.S. taxpayer were taxed both by the United States under its worldwide taxation system and by the source country where the income is generated. As described in our Prior 901(m) Report, the statutory provisions and regulations implementing the U.S. foreign tax credit regime generally allow a credit for foreign taxes despite differences between how taxable income may be computed under U.S. tax principles and how it is computed under those of the relevant foreign country. The foreign tax credit regime adopts no general requirement that, for a foreign tax credit to be available, the U.S. taxpayer must recognize an amount of income for U.S. purposes corresponding precisely to the income in the foreign tax base on which the foreign tax is imposed.[6]

[6] Indeed, detailed rules are included in current regulations to deal with these timing and base differences. *See, e.g.,* Treas. Reg. § 1.904-6(a)(1)(iv) (special rule for base and timing differences treats (x) foreign income tax imposed on an item the United States does not "see" as general limitation income and (y) foreign income tax

Section 901(m), which was enacted in 2010, represents a departure from this general principle that actual contemporaneous double taxation is not a condition for creditability.[7] Rather limited legislative history explaining section 901(m) is found in the Joint Committee on Taxation's report on the provision.[8] However, it appears Congress enacted section 901(m) to prevent certain tax-motivated planning techniques that allowed U.S. taxpayers in acquisition transactions to "step up" the U.S. tax basis but not the foreign tax basis in acquired assets to "hype" U.S. foreign tax credits.[9] Lower depreciation or amortization deductions for foreign than U.S. purposes with respect to the acquired assets result in higher foreign taxable income than the income recognized and included for U.S. purposes and higher foreign income taxes paid. The foreign income taxes at the resulting inflated effective tax rate may be used to reduce U.S. tax on income from unrelated transactions. Presumably, although foreign tax at the higher foreign effective rate is actually paid, this was viewed as an inappropriate situation for foreign tax credit relief because there is arguably no "double" taxation of the foreign income that the foreign

imposed on an item of income that the United States would "see" in another year as falling into the appropriate limitation category in the year in which the tax is imposed).

[7] Section 901(m) is not, however, unique in this respect. Section 909 and the "technical taxpayer" rules also address potential arbitrage that exploits differences between U.S. and foreign tax laws. *See* section 909 (providing that foreign taxes paid or accrued by a U.S. taxpayer that, as a result of certain events are separated from the income on which they were imposed, may not be taken into account until the taxpayer takes into account the related income for U.S. federal income tax purposes); Treas. Reg. § 1.901-2(f) (treating the person on whom foreign law imposes legal liability for a tax as the person who has paid such tax for purposes of sections 901 and 903 – with special rules for allocating the tax between persons who are taxed on their combined income and to owners of fiscally transparent entities).

[8] 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 2010) (hereinafter "JCT Report").

[9] At least with respect to section 338 transactions involving foreign target companies, we would note that taxpayers may be motivated by the administrative simplicity of starting with a clean slate (*e.g.,* with respect to earnings and profits history) as much as by a desire to hype foreign tax credits, whether or not this effect on foreign tax credits is the result.

system "sees" but the U.S. tax system does not.[10] While disallowing a foreign tax credit for such "hyped" taxes, the statute allows a deduction with respect to those foreign income taxes.[11]

Section 901(m) establishes three statutory categories of "covered asset acquisition" ("CAA"): (1) a qualified stock purchase to which section 338(a) applies, which would cover transactions for which an election is made under sections 338(g) or 338(h)(10); (2) any transaction treated as an acquisition of assets under the Code but as an acquisition of stock (or as disregarded) for foreign tax purposes; and (3) any acquisition of an interest in a partnership that has in effect a section 754 election.[12] The statute also provides regulatory authority to expand the scope of CAAs to "any other similar transaction." The JCT Report anticipated "that the Secretary will issue regulations identifying other similar transactions that result in an increase to the basis of assets for U.S. tax purposes without a corresponding increase for foreign tax purposes."[13] The statute also grants regulatory authority to exempt certain CAAs and relevant foreign assets ("RFAs") with respect to which the basis difference is *de minimis*.[14]

Under the statute, if a CAA occurs, the "disqualified portion" of the foreign income tax determined with respect to income or gain "attributable" to RFAs is not taken into account under

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[10] One can argue that this is not necessarily the case if the acquisition transaction results in gain being recognized that is taxable to a U.S. taxpayer in conjunction with the basis "step up" in the assets. On the other hand, the U.S. taxpayer that would be taxed in that case would be the U.S. seller who may be different than the U.S. taxpayer that will be reflecting income and crediting foreign taxes on that income following the acquisition. Section 901(m) does not generally attempt to distinguish between situations in which the assets' U.S. tax basis "step up" comes at the price of inclusion of a comparable amount of U.S. taxable gain and those in which it does not.

[11] Section 901(m).

[12] Section 901(m)(2).

[13] JCT Report, *supra* note 8, at 14.

[14] Section 901(m)(7).

sections 901(a), 902, 960 and 78.[15] RFAs with respect to any CAA include "any asset (including any goodwill, going concern value or other intangible) with respect to the acquisition if income, deduction, gain or loss attributable to the asset is taken into account in determining the relevant foreign income tax" attributable to such asset.[16] The statute generally defines the disqualified portion for any taxable year as the ratio of (1) the aggregate basis differences (not below zero) allocated to the year with respect to all RFAs for the taxable year divided by (2) "the income on which the foreign income tax … is determined." [17]

Under the statute, the "basis difference" with respect to any RFA is the excess of the adjusted basis for U.S. tax purposes immediately after the CAA over the adjusted basis for U.S. tax purposes immediately before the CAA.[18] Built-in loss assets are included in determining basis changes resulting from the CAA.[19] In determining when foreign taxes are deemed to be attributable to the U.S. tax basis "step up," the basis difference is generally allocated to (*i.e.*, taken into account with respect to) a tax year based on the applicable U.S. cost recovery method for the associated RFAs.[20] If there is a disposition of an RFA, any remaining basis difference is allocated to the year of disposition[21] and no basis is allocated to subsequent years.[22] The JCT

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[15] Section 901(m)(1) & (m)(3)(A).

[16] Section 901(m)(4).

[17] Section 901(m)(3)(A).

[18] Section 901(m)(3)(C)(i); JCT Report, *supra* note 8, at 14.

[19] Section 901(m)(3)(C)(ii).

[20] Section 901(m)(3)(B)(i).

[21] Section 901(m)(3)(B)(ii).

[22] Section 901(m)(3)(B)(ii)(II).

Report anticipated that future regulations could permit the use of foreign tax basis in lieu of U.S. tax basis to determine basis difference and thus the disqualified portion of foreign taxes.

For purposes of the discussion that follows, we think it important to reiterate some key aspects of the statutory scheme, also noted in the Prior 901(m) Report. Although the legislative history is sparse, it seems fair to infer from the statutory structure that section 901(m) is a targeted provision aimed at fairly specific tax-motivated transaction structures. Congress could, for example, have defined a covered asset acquisition broadly to include any acquisition that results in an increase in tax basis of assets for U.S. but not foreign income tax purposes, with exceptions to be provided by regulations. However, it did not. Congress defined very transaction-specific categories of CAAs (of the type that had in fact been employed in tax-motivated acquisition structures intended to hype foreign tax credits) with regulatory authority to expand these to "similar" transactions. Further, insofar as the statute fails to distinguish and exempt situations in which the U.S. basis "step up" corresponds to U.S. taxation of corresponding gain in the hands of a transferor, and permanently disallows the disqualified portion of the foreign tax rather than deferring it until corresponding income is recognized for U.S. purposes, the statute may apply to transactions within its scope in ways that arguably result in double taxation. Section 901(m) may represent rough justice as applied to acquisition transactions undertaken by the kinds of sophisticated multinational corporate groups that engaged in foreign tax credit planning transactions targeted by section 901(m). However, it cannot fairly be understood as being intended to limit creditability to cases of actual double taxation.[23] These features are relevant to the proper scope of the provision, including the breadth of the CAA definition and *de minimis* and other exceptions discussed later in this report.

[23] In this context it is also worth noting that Section 901(m) is a one-way street and does not take into account the consequences of transactions that may have the reverse effect, namely a "step up" of foreign basis with no

IV. THE REGULATIONS

A. The Notices and the Temporary Regulations

In 2014, the IRS took the first steps to providing guidance under section 901(m) by issuing Notice 2014-44 and Notice 2014-45 (the "Notices") addressing certain aspects of section 901(m).[24] The IRS also announced its intention to issue regulations addressing the application of section 901(m) to dispositions of assets following a CAA and to CAAs involving partnerships with section 754 elections. The Notices responded to transactions in which taxpayers intended to trigger dispositions of RFAs in which no (or limited) gain was recognized for foreign tax purposes but that arguably terminated the RFA status of the assets despite the continuing disparity between the U.S. and foreign tax basis following the disposition. Those taxpayers then took the position that the entire remaining basis difference was taken into account in the year of that disposition. The IRS noted that the JCT Report stated that "it is intended that [the rule about dispositions triggering inclusion of the remaining basis difference] 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," indicating congressional intent to limit disposition treatment (and therefore recognition of the remaining basis difference under section 901(m)) to situations in which all or at least part of the basis difference is recognized as income or gain for foreign tax purposes.

Under Notice 2014-44, section 901(m) continues to apply to an RFA until the entire basis difference in an RFA has been taken into account. The Temporary Regulations generally adopt the rules announced in the Notices without significant modification. They provide rules for how

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concomitant "step up" in U.S. basis, or a "step down" in U.S. tax basis, resulting in an "artificially" reduced effective foreign tax rate.

[24] Notice 2014-45, 2014-34 I.R.B. 388; Notice 2014-44, 2014-32 I.R.B. 270.

the portion of a basis difference relating to an RFA that is taken into account for the taxable year as a result of a disposition (the "Disposition Amount") is determined. A "disposition" is defined as an event that results in gain or loss being recognized with respect to an RFA for purposes of U.S or foreign income tax or both, such as a sale, abandonment or mark-to-market event.[25] If the disposition is fully taxable for both U.S. and foreign income tax purposes, the Disposition Amount equals the entire remaining "unallocated basis difference." If the disparity between U.S. and foreign basis is merely reduced as a result of a disposition, only a portion of the unallocated basis difference is taken into account. The effect of the disposition on the basis difference will depend upon whether the basis difference is positive or negative and whether gain or loss is recognized in the United States or in the relevant foreign country. In the case of a positive basis difference, there generally is a reduction in basis disparity upon the disposition of an RFA if gain is recognized for foreign income tax purposes ("Foreign Disposition Gain") or loss is recognized for U.S. income tax purposes ("U.S. Disposition Loss"). If the RFA has a positive basis difference, the Disposition Amount equals the lesser of (x) the Foreign Disposition Gain plus the absolute value of the U.S. Disposition Loss or (y) the unallocated basis difference. In the case of a negative basis difference, there generally is a reduction in basis disparity upon the disposition of the RFA if loss is recognized for foreign income tax purposes ("Foreign Disposition Loss") or gain is recognized for U.S. income tax purposes ("U.S. Disposition Gain"). If the RFA has a negative basis difference, the Disposition Amount equals the lesser of (x) the Foreign Disposition Loss plus the U.S. Disposition Gain (expressed as a negative amount) or (y) the unallocated basis difference.[26]

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[25] Treas. Reg. § 1.901(m)-1T(a)(10).

[26] Where the CAA in question resulted from a section 754 election/section 743(b) adjustment, the Disposition Amount with respect to an RFA only takes into account the amount of gains or losses attributable to the relevant partnership interest that was the subject of the CAA. If an RFA is subject to multiple section 743(b)

These rules, which were announced in Notice 2014-44, apply to dispositions occurring on or after July 21, 2014. Notice 2014-45 expanded the scope of the rules to dispositions occurring as a result of an entity classification election filed on or after July 29, 2014 that is effective on or before July 21, 2014, and the Temporary Regulations do the same.

In addition to adopting general rules consistent with the Notices, the Temporary Regulations also provide that U.S. Disposition Gain, U.S. Disposition Loss, Foreign Disposition Gain and Foreign Disposition Loss are determined taking into account gains on the disposition of an RFA that are deferred or otherwise not taken into account currently and losses on the disposition of an RFA that are deferred, disallowed or otherwise not taken into account currently.[27] They also clarify that section 901(m) continues to apply to any unallocated basis difference remaining after a transfer of an RFA for U.S. income tax purpose (a "Successor Transaction"), whether or not the transfer of the RFA is a "disposition," a CAA or a non-taxable transaction for U.S. income tax purposes.[28] An RFA thus can be the subject of multiple CAAs if the Successor Transaction is itself a CAA, but an asset received in exchange for an RFA does not become an RFA solely because the U.S. tax basis of the asset is determined by reference to the U.S. tax basis of the RFA.[29]

CAAs, special rules apply. If the same partnership interest is transferred multiple times, the RFAs will be treated as having unallocated basis differences resulting from the last such CAA only. If only a portion of a partnership interest is transferred, the historic unallocated basis difference must be allocated between the portions of the partnership interest transferred and retained.

[27] Treas. Reg. § 1.901(m)-1T(a)(18), (19), (43) & (44).

[28] Treas. Reg. § 1.901(m)-6T(b)(1) & (2).

[29] Treas. Reg. § 1.901(m)-6T(b)(4).

The Temporary Regulations also helpfully exclude gross-basis withholding taxes from the definition of "foreign income taxes" for purposes of section 901(m).[30] This is appropriate and seems consistent with the purposes of section 901(m) because gross-basis taxes, which are not imposed on *net* income, are not generally affected by basis-driven disparities in cost recovery deductions and gain upon disposition.

B. The Proposed Regulations

While the Temporary Regulations largely reflect and clarify the principles of the Notices, the Proposed Regulations introduce numerous additional definitions, add three new CAAs, provide elaborate computational and allocation rules to address hybridity and multijurisdictional income-generating activities, provide for a foreign basis election and add a *de minimis* rule.

1. *New CAAs*

As noted above, the statute grants authority to expand the definition of a CAA to include "other similar transactions." The Proposed Regulations add three new CAAs: (1) an acquisition of assets treated as an acquisition of assets for U.S. income tax purposes and the acquisition of an interest in a fiscally transparent entity for foreign income tax purposes,[31] (2) a distribution by a partnership of one of more assets the U.S. tax basis of which is determined under section 732(b) or section 732(d) or which causes the U.S. basis of the partnership's remaining assets to be adjusted under section 734(b), but only if the transaction results in an increase in the U.S. basis of the assets distributed or retained without a corresponding increase in the foreign basis of such

[30] Treas. Reg. § 1.901(m)-1T(a)(21).

[31] Prop. Treas. Reg. § 1.901(m)-2(b)(4). The Proposed Regulations give the following as an example: U.S. parent and its disregarded entity each acquire 50% of the interests in a foreign entity treated as a partnership for U.S. and foreign tax purposes. For foreign tax purposes, the entity remains a partnership. However, for U.S. federal income tax purposes, U.S. parent is deemed to acquire all the assets of the foreign entity. Prop. Treas. Reg. § 1.901(m)-2(e), Example (1).

assets[32] and (3) an acquisition of assets for both U.S. and foreign income tax purposes, but only if the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets.[33] The first new category is a CAA even if there is no increase in the U.S. tax basis of the relevant assets.[34]

2. *RFAs and the Calculation of Foreign Taxes for Which the Foreign Tax Credit Is Disallowed under Section 901(m)*

An asset generally is an RFA with respect to a foreign income tax if income, deduction, gain or loss attributable to the asset is taken into account immediately after the CAA or would be so taken into account if the asset were to give rise to income, deduction, gain or loss at that time.[35] If the Proposed Regulation had adopted a requirement of "tracing" foreign income and tax to the specific RFA, the concept of an RFA would be fairly self-evident. As discussed further below, however, the Proposed Regulations adopt a formulaic approach (rather than tracing), which compares the basis differential allocated to a year to the foreign income of the relevant entity. Presumably, this raised concerns that taxpayers could exploit the formulaic test by moving assets. For example, a US corporation could acquire a corporate target in one jurisdiction (country A), a low tax jurisdiction, from an unrelated seller and make a section 338 election. None of the assets would be RFAs with respect to country B, a high tax jurisdiction, because items from those assets would not be taken into account for purposes of country B

[32] Prop. Treas. Reg. § 1.901(m)-2(b)(5).

[33] Prop. Treas. Reg. § 1.901(m)-2(b)(6). The Proposed Regulations give the following as an example: CFC1 transfers an asset to CFC2 in exchange for CFC2 common stock and cash. For U.S. federal income tax purposes, CFC1 recognizes gain on the exchange under section 351(b) and CFC2's basis in the asset is increased by that gain under section 362(a). There is, however, no increase in the foreign tax basis of the asset. Prop. Treas. Reg. § 1.901(m)-2(e), Example (2).

[34] If there is no U.S. basis increase, the disqualified tax amount generally would be zero. However, if such a transaction occurs as part of a series of related CAAs that are aggregated, and if a foreign basis election is made for the overall aggregated CAA, the transaction would become subject to the section 901(m) regime.

[35] Prop. Treas. Reg. § 1.901(m)-2(c)(2).

income tax immediately after the acquisition. The target could then contribute the assets to a transferee in country B in a section 351 transaction in which it recognizes no gain or loss and, for purposes of the country B income tax, the transferee takes the assets with their lower historic bases. After this transfer, income, gain, deduction or loss from the assets would be taken into account for purposes of the country B income tax.

An asset therefore will also become an RFA, if, pursuant to a plan or series of related transactions that have a principal purpose of avoiding the application of section 901(m), the asset, which was not relevant in determining foreign income for purposes of a particular foreign income tax immediately after a CAA, subsequently becomes relevant in determining foreign income under that tax.[36] A principal purpose of avoidance is deemed to exist if the asset is taken into account in determining foreign income within a one-year period following the CAA (or would be so taken into account if the asset were to give rise to income, deduction, gain or loss within that one-year period). This provision would apply to assets that were relevant under one foreign tax regime at the time of the CAA and within one year become subject to a second foreign tax regime. It would also apply to assets that were only relevant for U.S. federal income tax purposes at the time of the CAA and within one year become subject to a foreign income tax regime.

The Proposed Regulations make some important changes to the methodology for calculating the portion of foreign income taxes paid for which section 901(m) denies a foreign tax credit. Importantly, as noted above, the Proposed Regulations do not require actual tracing of foreign income tax to particular RFAs with a basis disparity. Instead, the Proposed Regulations implement an aggregate approach. They calculate the disallowed amount with respect to a

[36] Prop. Treas. Reg. § 1.901(m)-2(c)(3).

"section 901(m) payor," which is a person eligible to claim a foreign tax credit under section 901(a) (whether or not that person chooses to do so) or a section 902 corporation (as defined for purposes of section 909) (a "Section 901(m) Payor"). A foreign tax credit is denied for the "disqualified tax amount" of a Section 901(m) Payor, which is defined as the lesser of the foreign income tax for the year and the "tentative disqualified tax amount."[37] Calculations are made separately for each limitations category. The "tentative disqualified tax amount," in turn, is defined as (1) the product of (x) the foreign income tax (increased by third-country taxes that are creditable under the relevant foreign country tax rules) and (y) a fraction (which can never exceed one) the numerator of which is the "aggregate basis difference" (as described below) and the denominator of which is the "allocable foreign income" reduced by (2) any creditable third country taxes that give rise to a "disqualified tax amount" with respect to another foreign tax.[38] The "disqualified tax amount" is zero for a U.S. taxable year if the aggregate basis difference is a negative amount, relevant foreign income is zero or negative or the relevant foreign income tax amount is zero.[39]

"Aggregate basis difference" means the sum of the "allocated basis differences" for a U.S. taxable year plus the "aggregate basis difference carryover" from the immediately preceding year, determined separately for each limitation category.[40] Allocated basis difference with respect to an RFA and a foreign tax is the sum of the "cost recovery amounts" and

[37] Prop. Treas. Reg. § 1.901(m)-3(b)(2)(i).

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

[39] Prop. Treas. Reg. § 1.901(m)-3(b)(2)(iv).

[40] Prop. Treas. Reg. § 1.901(m)-1(a)(1).

Disposition Amounts assigned to a U.S. taxable year of a Section 901(m) Payor.[41] A "cost recovery amount" for an RFA (a "Cost Recovery Amount") is determined by applying the applicable U.S. cost recovery method (*e.g.*, depreciation, amortization, depletion) to the basis difference of the RFA.[42] An "aggregate basis difference carryover" arises if the "disqualified tax amount" is zero, the "aggregate basis difference" for a year exceeds allocable foreign income or the "tentative disqualified tax amount" exceeds the "disqualified tax amount."[43] If a corporation acquires the assets of a Section 901(m) Payor in a transaction to which section 381 applies, that corporation succeeds to the aggregate basis difference carryovers of the Section 901(m) Payor.[44] Similarly, an aggregate basis difference carryover with respect to a Section 901(m) Payor moves from one person or entity subject to foreign income tax (a "Foreign Payor") to another where the second Foreign Payor acquires substantially all the assets of the first and the Section 901(m) Payor holds an interest in the second Foreign Payor.[45] An anti-abuse rule applies where assets are moved between foreign persons in a transaction that is described in neither of the two preceding sentences if there is a principal purpose of avoiding the application of section 901(m).[46]

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[41] Prop. Treas. Reg. § 1.901(m)-1(a)(5). Under an anti-abuse rule, a built-in loss RFA is not taken into account in computing an allocated basis difference if any RFA, including a RFA other than a built-in loss RFA, is acquired with a principal purpose of using one or more built-in loss RFAs to avoid the application of section 901(m). Prop. Treas. Reg. § 1.901(m)-8(c).

[42] Treas. Reg. § 1.901(m)-5T(b)(2), Prop. Treas. Reg. § 1.901(m)-5(b)(3).

[43] Prop. Treas. Reg. § 1.901(m)-3(c).

[44] Prop. Treas. Reg. § 1.901(m)-6(c)(1).

[45] Prop. Treas. Reg. § 1.901(m)-6(c)(2).

[46] Prop. Treas. Reg. § 1.901(m)-6(c)(3).

The formulaic approach to tracking basis disparities with respect to RFAs is in many ways more administrable than an approach that requires tracing of the foreign tax consequences of basis disparities arising from CAAs. We agree that the approach is more objective and will result in more clear-cut answers (for both taxpayers and the IRS) than tracing. We therefore support the decision to adopt that approach rather than tracing. The approach nevertheless is not without administrative costs insofar as it has led the drafters of the Proposed Regulations to adopt complex rules to address fairly typical fact patterns in corporate multinational groups involving multiple (in some cases hybrid) entities, multiple RFAs, multiple foreign taxing jurisdictions and multiple owners (resulting from ownership transfers within a taxable year and/or different entities being treated as owning an RFA for U.S. and foreign income tax purposes and/or different entities being treated as owing the foreign tax and/or entitled to claim a U.S. foreign tax credit). The Proposed Regulations provide a complex set of rules for allocating foreign income[47] as well as Cost Recovery Amounts and Disposition Amounts in these circumstances.[48] Detailed rules address the respective allocations of Cost Recovery Amounts and Disposition Amounts where the U.S. owner of an RFA is a fiscally transparent entity or a reverse hybrid.[49] Additional rules allocate foreign income as well as Disposition Amounts in connection with mid-year transactions and address inconsistent U.S. and foreign taxable years.

As we believe that the Proposed Regulations, while highly complex, generally reach the "correct" results within the framework chosen by Treasury and the IRS and are not recommending changes to specific aspects of these allocation rules, this report does not describe the allocation rules in greater detail. We think it worth noting, however, that the complexity of

[47] Prop. Treas. Reg. § 1.901(m)-3(b)(2)(iii).

[48] Prop. Treas. Reg. § 1.901(m)-5.

[49] Prop. Treas. Reg. § 1.901(m)-5(d) & (g).

this elaborate regime will be difficult for all but the most sophisticated taxpayers and advisors involved in large, intensively structured acquisition transactions to apply properly in practice. We think this is important in evaluating the proper scope of the CAA definition and applicable exceptions.

3. *Foreign Basis Election*

As discussed above, the statute measures the relevant basis difference as the excess of the adjusted U.S. tax basis immediately after the CAA over the adjusted U.S. tax basis immediately before the CAA, focusing entirely on the "step up" in U.S. tax basis. The statutory test thus ignores the fact that a CAA might result in a partial "step up" in foreign tax basis. While comparing U.S. to foreign bases differences of RFAs following a CAA in determining the disqualified portion of a foreign tax might better capture in some respects the potential arbitrage at which the statute takes aim, differences between the U.S. and foreign basis may also reflect differences unrelated to the acquisition (such as different cost recovery methods and periods) which are not the focus of section 901(m) and which are inherent in a foreign tax credit regime that does not generally tie availability of credits to both the United States and the relevant foreign jurisdiction "seeing" the same items of income, deductions, gain or loss. The JCT Report anticipated that future regulations would "[identify] those circumstances in which, for purposes of determining the adjusted basis of such assets immediately before the covered asset acquisition, it may be acceptable to utilize the basis of such assets under the law of the relevant jurisdiction or another reasonable method."

The Proposed Regulations maintain the general rule of comparing U.S. tax basis before and after the CAA but permit an election to compute the basis difference by comparing U.S.

basis in an RFA to foreign basis in the RFA, in each case immediately after the CAA.[50] The election is made separately for each CAA (though a series of related CAAs occurring as part of a plan are treated as one), with respect to each foreign income tax and with respect to each Foreign Payor. The election is generally made by the person treated as the owner of the RFA for U.S. federal income tax purposes. Where that owner is a partnership, however, each partner is permitted to make an independent partner-level election. A foreign basis election is irrevocable. If a foreign basis election is made with respect to a subsequent CAA, any unallocated basis difference with respect to prior CAAs will not be taken into account under section 901(m) and the only relevant basis difference going forward will be the basis difference with respect to the subsequent CAA.[51] Given the tension described above between capturing the U.S.-foreign basis differential that actually gives rise to the "hyped" effective foreign tax rate and the need to avoid subjecting (permissible) tax basis differences unrelated to the acquisition to the credit disqualification test, we think the elective approach adopted by the Proposed Regulations is a sensible, administrable approach.

The foreign basis election is generally available for CAAs occurring on or after the date of publication of final regulations. However, taxpayers can rely on the election if they apply the Proposed Regulations to all CAAs occurring on or after January 1, 2011 (or with respect to the rules in Proposed Regulations section 1.901(m)-2 to all CAAs occurring on or after December 7, 2016).[52] For purposes of this consistency requirement all persons related within the meaning of

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[50] Prop. Treas. Reg. § 1.901(m)-4(c)(1).

[51] Prop. Treas. Reg. § 1.901(m)-6(b)(4)(ii).

[52] The rules in Proposed Regulations section 1.901(m)-2 generally introduce the new CAAs and address how an asset becomes an RFA with respect to a foreign income tax. Taxpayers will not be required to apply Proposed Regulations section 1.901(m)-2(d), which cross-references a provision of the Temporary Regulations to the effect that, for transactions occurring on or after January 1, 2011 and before July 21, 2014 (other than transactions effective on or before July 21, 2014 due to an entity classification election filed on or after July

sections 267(b) or 707(b) are treated as a single taxpayer.[53] If a taxpayer chooses to apply the foreign basis election to CAAs occurring on or after January 1, 2011, the election will be effective if it is reflected on a timely filed amended federal income tax return (or returns) filed no later than one year following the date of publication of final regulations.[54]

4. *De Minimis Rules*

The statute grants authority to exempt RFAs with respect to which the basis difference is *de minimis*. The Proposed Regulations set forth these *de minimis* rules.[55] Generally, under the Proposed Regulations, a basis difference with respect to an RFA is not taken into account for purposes of section 901(m) if either (1) the sum of all basis differences for all RFAs with respect to the CAA is less than the greater of $10 million and 10% of the total U.S. basis of all RFAs immediately after the CAA ("Cumulative Basis Difference Exemption") or (2) the RFA is part of a class (using the seven asset classes set forth in Treasury Regulations section 1.338-6(b)) for which the sum of basis differences of all RFAs in the class is less than the greater of $2 million and 10% of the total U.S. basis of all RFAs in the class ("RFA Class Exemption").[56] If one or more CAAs occur as part of a plan, the Cumulative Basis Difference Exemption and the RFA Class Exemption are applied on an aggregate basis.[57] The exemptions are applied when an asset subject to a CAA first becomes an RFA, which may occur as a result of transactions within the one-year period following the CAA. If an asset is also an RFA with respect to a subsequent

29, 2014), whether a transaction is a CAA or an asset is an RFA is determined under section 901(m)(2) and 901(m)(4) respectively.

[53] Prop. Treas. Reg. § 1.901(m)-4(g)(3).

[54] Prop. Treas. Reg. § 1.901(m)-4(c)(6).

[55] Prop. Treas. Reg. § 1.901(m)-7.

[56] Prop. Treas. Reg. § 1.901(m)-7(b).

[57] Prop. Treas. Reg. § 1.901(m)-7(d)(2).

CAA, the *de minimis* exemptions are applied only to any additional basis difference created by the subsequent CAA. There is no retesting of unallocated basis differences from prior CAAs.[58]

If a CAA is part of a series of CAAs occurring pursuant to a plan and there are multiple owners of RFAs attributable to those CAAs, the Cumulative Basis Difference Exemption and the RFA Class Exemption are tested twice – once at the level of each U.S. asset owner and once with respect to all RFAs owned by all relevant asset owners.[59] Moreover, where the transferor and transferee in a CAA are related persons within the meaning of sections 267(b) or 707(b), the thresholds applicable to the Cumulative Basis Difference Exemption and the RFA Class Exemption are cut in half.[60] There are also two anti-abuse rules that further restrict the *de minimis* exceptions. The first disapplies the *de minimis* rules altogether if the transferor and transferee in the CAA are related and the CAA was entered into or structured with a principal purpose of avoiding the application of section 901(m).[61] The second provides that a built-in loss RFA is not taken into account for purposes of the Cumulative Basis Difference Exemption and the RFA Class Exemption if any RFAs, including RFAs other than built-in loss RFAs, are acquired with a principal purpose of avoiding the application of section 901(m).[62]

5. *Effective Dates*

In general, the Temporary Regulations have retroactive effect as of July 21, 2014, consistent with the Notices. The Proposed Regulations are generally only effective with respect

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[58] Prop. Treas. Reg. § 1.901(m)-7(d)(3).

[59] Prop. Treas. Reg. § 1.901(m)-7(c)(2).

[60] Prop. Treas. Reg. § 1.901(m)-7(c)(1).

[61] Prop. Treas. Reg. § 1.901(m)-7(e).

[62] Prop. Treas. Reg. § 1.901(m)-8(c).

to CAAs occurring on or after the date the Proposed Regulations are finalized.[63] Until then taxpayers are generally required to determine whether a transaction is a CAA or an asset is an RFA by applying sections 901(m)(2) and (m)(4)[64] and otherwise by applying the statute and Notices on a reasonable basis. However, taxpayers may rely on the Proposed Regulations prior to finalization as long as three consistency requirements are met: First, a taxpayer must apply Proposed Treasury regulations section 1.901(m)-2 (other than section 1.901(m)-2(d), as discussed in part IV.iii above) to all CAAs occurring on or after December 7, 2016. This will require treating all transactions that fall within the scope of the three new CAAs as subject to section 901(m) and determining whether an asset is an RFA based on the rules in the Proposed Regulations. Second, the taxpayer must apply the remainder of Proposed Regulations, other than Proposed Treasury regulations section 1.901(m)-4(e),[65] with respect to all CAAs occurring on or after January 1, 2011. This will require application of the elaborate calculation and allocation rules of the Proposed Regulations (as well as permit use of the foreign basis election and *de minimis* rules) with respect to all such CAAs. Finally, all persons related within the meaning of section 267(b) or section 707(b) are treated as a single taxpayer for these purposes and therefore must apply the rules consistently.

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[63] Treas. Reg. § 1.901(m)-1T(b), -2T(f), -4T(e) & (g), -5T(i) & -6T(d); Prop. Treas. Reg. § 1.901(m)-1(b), -2(f), -3(d), -4(e) & (g), -5(i), -6(d); -7(g) & -8(d).

[64] Prop. Treas. Reg. § 1.901(m)-2(d); Treas. Reg. § 1.901(m)-2T(d).

[65] Proposed Treasury regulations section 1.901(m)-4(e) cross-refers to the Temporary Regulations addressing how "basis difference" for an RFA is determined with respect to a CAA occurring on or after January 1, 2011 but before July 21, 2014 (other than a CAA occurring as a result of a retroactive entity classification election filed on or after July 29, 2014 with effect on or before July 21, 2014, which is subject to the Temporary Regulations). For such a CAA, basis difference in an RFA is the basis difference (within the meaning of section 901(m)(3)(C)(i)) that had not yet been taken into account under section 901(m)(3)(B) as of July 21, 2014 (or in the case of a retroactive entity classification election filed on or after July 29, 2014, prior to the deemed transactions resulting from the entity classification election). Treas. Reg. § 1.901(m)-4T(e).

V. DISCUSSION OF RECOMMENDATIONS

A. Scope of New CAAs

The statute grants regulatory authority to expand the definition of CAA to cover "any other similar transaction." The first two new CAAs added by the Proposed Regulations designate clearly defined transactions that bear close resemblances to the statutorily designated original CAAs. For example, the second new category essentially functions as a backstop to the original CAA resulting from acquisitions of interests in partnerships that have in effect a section 754 election. Under that new CAA, if a CFC acquires an interest in a foreign partnership that owns appreciated assets and has not made a section 754 election, receives a distribution of an appreciated partnership asset within two years and elects to adjust the asset's basis under section 732(d), there will be a U.S. basis "step up" but no "step up" for foreign income tax purposes. Because the basis adjustment under section 732(d) is conceptually analogous to the adjustment that would have occurred if the partnership had had a section 754 election in place (and that would have triggered one of the original CAAs set forth in the statute), this is a sensible addition. Accordingly, we agree that the first two new CAAs are an appropriate expansion of the CAAs described in the statute.

The third new CAA, however, covers any transaction "treated as an acquisition of assets for both U.S. income tax and foreign income tax purposes, provided the transaction results in an increase in the U.S. basis without a corresponding increase in foreign basis of one or more assets." We are concerned with the breadth and lack of transactional specificity of this proposed CAA.

We do not doubt that this extension is within the authority granted by the statute to extend the definition of CAA to other transactions similar to the statutorily defined CAAs. Insofar as the new CAA involves some form of acquisition transaction that results in a basis

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differential that could in theory raise the policy concerns presented by the statutory CAAs, it can certainly reasonably be considered "similar." The Proposed Regulations set forth a specific example of a CAA that falls with the scope of Proposed Regulations section 1.901(m)-2(b)(6). In that example, CFC1 transfers an asset to CFC2 in exchange for CFC2 common stock and cash. For U.S. federal income tax purposes, CFC1 recognizes gain on the exchange under section 351(b) and CFC2's basis in the asset is increased by that gain under section 362(a). There is, however, no increase in the foreign tax basis of the asset.[66] We agree that the specific transaction set forth in the example is an appropriate candidate for treatment as a CAA.[67] Indeed, asset acquisition transactions involving boot that are treated as reorganizations for U.S. federal income tax purposes under sections 368 and 351 or "busted" section 351 transactions may generally be appropriate candidates for CAA treatment if they result in a U.S.-foreign basis differential.

Nevertheless, we question whether the current and very broad CAA definition is advisable or consistent with the "spirit" of the statutory provision. Unlike the other types of CAAs (both statutory and regulatory), which address fairly specific transactional formats, a category that involves any acquisition of assets that leads to a U.S.-foreign tax basis differential is an open-ended category that is more akin to an anti-abuse rule. A transaction could be captured within this category even if it involved no particular U.S. tax planning, let alone planning to hype foreign tax credits. Taxpayers could stumble into this category of CAA inadvertently in connection with ordinary-course asset acquisitions and internal reorganizations

[66] Prop. Treas. Reg. § 1.901(m)-2(e), Example (2).

[67] We would, however, note that where both CFCs are in the same country, there would be no inconsistency between the group's earnings and profits for U.S. and foreign purposes other than that the earnings and profits would be accelerated for U.S. tax purposes. It therefore could be argued that concerns regarding availability of the U.S. foreign tax credit under these facts would be more appropriately addressed under section 909 rather than under section 901(m).

simply as a result of discrepancies between the applicable U.S. and foreign income tax rules. For example, we understand that the United Kingdom has rules relating to the disposition of, and reinvestment in, business assets that are significantly broader than section 1031. These rules do not require the old and new assets to be of the same type or to be used in the same trade or business and can apply where one affiliate sells assets and another acquires new assets. Under those provisions, a controlled foreign corporation in the United Kingdom could sell business assets and, for United Kingdom tax purposes, defer gain and carry the historic basis of the disposed assets over to other business assets newly purchased by it (or certain of its affiliates) generally within a 3-year period. These kinds of transactions are likely to occur on a routine basis, but the acquisition of the new assets would qualify as a CAA under the Proposed Regulations because there would be an acquisition of assets that would have a cost basis for U.S. tax purposes but a substituted basis for United Kingdom tax purposes.

Although we believe that section 901(m) was targeted at specific transactions that were being used to hype foreign tax credits as a planning matter, we are not suggesting a general principle that transactions should not be treated as CAAs absent subjective intent to achieve that tax result or that a principal purpose of achieving that result should be made a requirement of CAA treatment. That would make the rules difficult to administer and enforce. However, any theoretical overbreadth is mitigated in the case of the other categories of CAAs by the very specific transactional forms they target. These involve transactions unlikely to be entered into by U.S. taxpayers (including groups with affected U.S. owners) without careful tax planning, during which the impact of any potential basis differential can be assessed and in many cases avoided. If at the end of that process, there is a basis differential that would have the effect of hyping foreign tax credits, there is no policy reason to permit that result.

The third new category of CAA, however, picks up any asset acquisition (subject only to the *de minimis* exception). In practice, however, to determine whether asset transfers meet a *de minimis* exception will require a review of every asset transfer, however small, to determine whether it could be considered part of a broader integrated transaction involving other assets transfers, whether there is a basis difference and whether any exception is applicable.[68] Indeed, it is not even the case that asset transfers as part of a broader transaction will necessarily have been subject to careful U.S. tax planning and analysis. Given the broad scope of the successor rules under the Regulations (which do not require that a transaction have been "relevant" to any U.S. taxpayer to be a CAA), an acquirer of a foreign group may "inherit" CAA attributes from prior CAAs conducted by the group at a time when any U.S. tax impact may have been marginal in the hands of any original U.S. indirect owners.[69] This new category of CAA will therefore necessitate burdensome transactional due diligence aimed at identifying post-effective date transactions (of which there could be many) that might have fallen within its scope.

We do not think that the possibility that some asset acquisition transactions that create a basis differential might escape section 901(m) without this broad category of CAA is a compelling reason to have it, given the difficulties above. As noted above, the U.S. foreign tax credit regime generally accepts that the U.S. and foreign income tax systems do not always "see" the same items and attributes, and section 901(m) represents an exception from this general

[68] While unclear from the Regulations, we assume, given the general focus of the section 901(m) rules on *aggregate* basis difference, that if multiple assets are transferred as part of an integrated transaction or plan, the combined transaction and basis difference is tested, rather than each component as a separate CAA. Given the breadth of this new CAA, however, it is theoretically possible that certain asset transfers that are part of an integrated transaction could be taxable transfers for both U.S. and foreign purposes while others could not be for both purposes. The Proposed Regulations do not address how taxpayers are to reconcile these kinds of potential anomalies.

[69] Given the definition of CAA in the Regulations, it appears that a prior transaction that occurred at a time when U.S. tax consequences were not relevant for any U.S. taxpayer could nonetheless technically be a CAA that a subsequent U.S. acquirer must reflect.

principle aimed at specific types of transactions identified by Congress. We see no reason to emphasize theoretical purity at the cost of administrability solely in the case of acquisition transactions, while other kinds of base differences are permitted. As explained previously, the effect of section 901(m) is potentially overbroad, given both the absence of any exception for U.S.-foreign basis disparities traceable to an actual U.S. taxable inclusion of corresponding gain and the permanent disallowance rather than deferral of the affected foreign tax credits. Thus, a taxpayer that stumbles into a basis differential subject to the CAA rules may in fact be worse off than if it had planned into that result. In light of this, we believe that it is appropriate to interpret the statutory grant of authority to identify "similar transactions" narrowly and to limit new CAAs to specific transactions that are generally likely to achieve the same hyping of foreign tax credits as the three original CAAs and that typically involve intensive U.S. tax planning (even if this is not a required feature of a CAA).

In order to give effect to the statutory requirement to designate "similar transactions," we recommend replacing the open-ended sixth CAA in the Proposed Regulations with the specific transaction described in the example. Moreover, this category could be expanded to treat any reorganization with boot or "busted" section 351 transaction that achieves a similar result as a CAA. Treasury and the IRS could then identify any further specific transactions that result in the same perceived abuse at which section 901(m) is aimed by notice. If Treasury and the IRS believe that the resulting list of CAAs may be insufficient to achieve the purposes of section 901(m), we suggest crafting an anti-abuse rule that would treat any transaction as a CAA if it was structured with a principal purpose of avoiding the specific categories of transactions set forth in the revised Proposed Regulations section 1.901(m)-2(b).

We recognize, however, that our recommended approach may permit various as-yet unidentified transactions that are problematic and that the government may not view the process of issuing notices to identify those transactions as an effective mechanism to prevent all abusive transactions. Treasury and the IRS therefore may decide to retain the catch-all category set forth in the Proposed Regulations. In that case, we would recommend that Treasury and the IRS carefully study the administrability and fairness concerns we have raised, including in particular (1) the scope of due diligence that would be required to identify all potential CAAs (including in situations where prior CAAs may have occurred while they were not "relevant" to any direct or indirect U.S. owners), and (2) the potential disallowance of credits in situations in which a U.S. taxpayer (which could be a member of the same group of related companies) recognized gain or earnings and profits for U.S. federal income tax purposes in the CAA that will have "paid for" the U.S. basis "step-up." Potential over-breadth of the "catch-all" CAA could be mitigated if it were at least limited to asset sales structured with a specific purpose of achieving an increase in basis for U.S. federal income tax purposes and a carryover or substituted basis for foreign tax purposes, taking into account all surrounding facts and circumstances – with a rebuttable presumption that no such purpose was present if no U.S. tax advice was received in connection with the asset sale the CAA status of which is being tested. Other potentially relevant facts and circumstances include whether the asset acquirer (or a related person) recognized an amount of taxable income or gain (or increase in earnings and profits) in connection with the asset sale that corresponded to the increase in basis (in each case, for U.S. federal tax purposes). In the case in which a related person recognizes the income, gain or an increase in earnings and profits, it also would be relevant to consider whether the U.S. taxpayer's credit with respect to foreign taxes

attributable to income from the assets that would otherwise be RFAs will be suspended under section 909 until it includes the income.

A further factor that merits consideration is whether a U.S. taxpayer that becomes a person with respect to whom assets would be RFAs if a prior asset sale had been treated as a CAA was a direct or indirect shareholder of the asset acquirer (or otherwise related to such a person) at the time of the original asset sale that is subsequently being tested for CAA status. Where it was not a direct or indirect shareholder of an asset acquirer (or otherwise related to such a person), we recommend excluding an asset acquisition from CAA status, provided (x) the U.S. taxpayer did not know or have reason to know, in the exercise of normal commercial due diligence, that the assets were previously acquired in an asset sale structured with a purpose achieving an increase in basis for U.S. federal income tax purposes and a carryover or substituted basis for foreign tax purposes, and (y) its own acquisition of the assets was not structured by seller with a purpose of avoiding the successor rules of the Temporary Regulations.

B. Raising the *De Minimis* Threshold and Eliminating the "Affiliate Haircut"

As described above, the Proposed Regulations establish a highly complex regime for allocating income, Cost Recovery Amounts and Disposition Amounts across different jurisdictions and entities, and the Temporary Regulations include far-reaching successor rules. While we believe this complexity is generally justified to account for the many complications resulting from hybridity and the multijurisdictional operations of many taxpayers, we also believe that a robust *de minimis* rule is critical to ensure that taxpayers are not overburdened by the resulting complicated and costly compliance requirements in situations where the overall abuse potential is limited. Moreover, the proposed greatly expanded scope of CAAs (especially if the new CAA in Proposed Treasury regulations section 1.901(m)-2(b)(6) is retained) makes such a *de minimis* rule all the more important.

Given this background, while we agree that 10% of the total U.S. asset bases of the relevant entities or of assets in a given class is an appropriate threshold for larger transactions, we believe that the current fixed dollar thresholds of $10 million for the Cumulative Basis Difference Exemption and $2 million for the RFA Class Exemption are too low. These fixed dollar thresholds sweep any target (or group of related targets) with more than $100 million of total assets (or $20 million of assets in a particular class) into the percentage rule and deny it the benefit of an added cushion, greatly expanding the number of smaller transactions that fall within the complex and costly regime established by the Proposed Regulations. We note that the tax benefit, even in the unlikely event that all of the depreciation could be claimed in the first post-acquisition year, would be only be around $3.5 million, and in more likely scenarios where the basis recovery is more deferred, would be lower still. We believe that the potential basis differential with respect to transactions of this magnitude would not generate a sufficient foreign tax credit benefit to justify intensive tax planning. For example, a threshold of $15 million for the Cumulative Basis Difference Exemption seems more reasonable. Given that the shortest generally applicable recovery period is three years, a $15 million basis differential generally would result in a tax benefit of at most $1.75 million per year, or $5.25 million over three years. Section 901(m) itself includes authority to establish a *de minimis* exception. In order to give effect to the clear congressional intent to exclude transactions that are not large enough to represent an abuse of the U.S. foreign tax credit regime, we believe the thresholds should be raised so that a meaningful number of smaller transactions will in fact be exempt.

There are many valid business reasons why a corporate group might wish to restructure its entities and operations and, in some instances, the restructuring steps may involve CAAs. We are therefore also concerned that the affiliate haircut further undermines the usefulness of the

proposed *de minimis* exception. This would be especially true if final regulations were to retain the open-ended category of CAA set forth in Proposed Regulations section 1.901(m)-2(b)(6), but would remain a concern even if our suggested replacement were included because our proposal for new Proposed Regulations section 1.901(m)-2(b)(6) would nonetheless encompass many intragroup restructurings in which a mismatch between foreign and U.S. asset basis may result simply from differences between how U.S. and foreign rules relating to the taxation of corporate reorganizations operate. Moreover, outside the context of multinational corporate groups, CAAs could be triggered as a result of routine occurrences. For example, in a multinational partnership of individuals that has made a section 754 election, a CAA could result every time an individual partner dies. If each of those occurrences constitutes a CAA that triggers the application of the Proposed Regulations, the result would be a cascading compliance burden that is not proportionate to the potential hyping of U.S. foreign tax credits.

Fundamentally, a *de minimis* exception reflects an administrative recognition that any theoretical tax policy objective is outweighed by the administrative burden of the rules in the context of small transactions where the resulting tax arbitrage is presumably small. Whatever the level is judged to be *de minimis* for this purpose (whether in absolute terms or based on the size of the taxpayer itself), that test should be different for related parties only if the fact that the parties are related somehow makes the rules less burdensome than they are for unrelated parties or makes the likelihood of tax arbitrage higher (*e.g.*, because there is less frictional constraint on intra-group transactions that hype credits than otherwise). We see no reason why that is likely to be the case in this context.

We therefore do not believe that the automatic 50% haircut of the applicable *de minimis* thresholds in the context of related-party transactions is appropriate and recommend eliminating

it. We believe that the anti-abuse rules set forth in the Proposed Regulations are more appropriately targeted to deny the *de minimis* exceptions in cases where related parties have engaged in deliberate structuring efforts to avoid the application of Section 901(m).

C. Foreign Basis Election

By adding the foreign basis election, Treasury and the IRS have implemented congressional intent as described in the JCT Report. We believe that in many cases the foreign basis election will eliminate the need for taxpayers to engage in costly efforts to reconstruct the U.S. tax basis of assets for which the historic foreign owners did not need to maintain U.S. tax calculations. As a result, it will greatly simplify the administrative burdens of complying with the complex regime of the Proposed Regulations and should significantly enhance compliance with these rules. For the same reason, we commend Treasury and the IRS for permitting taxpayers to apply the foreign basis election retroactively to CAAs that have occurred since 2011.

However, under the Proposed Regulations, the foreign basis election is only available retroactively if a taxpayer and all related parties apply the Proposed Regulations to all CAAs occurring on or after January 1, 2011. We understand that Treasury and the IRS are concerned with taxpayers cherry-picking between the statutory regime, and the Proposed Regulations and therefore have imposed a consistency requirement. While that requirement appears appropriate for tax years that remain open and with respect to which taxpayers could engage in cherry picking the regime that gives them the best result for a given CAA, we believe the requirement is unfair where some tax years of the taxpayer or its affiliates since 2011 are already closed and the relevant parties therefore are stuck with the regime that existed before the issuance of the Proposed Regulations with respect to CAAs occurring during, and initially reflected in returns for, those closed years. Given the significant cost and complexities that result from a taxpayer

being denied the foreign basis election with respect to transactions in years for which returns have not yet been filed, we believe the consistency requirement in the Proposed Regulations is unduly burdensome. We therefore recommend that the consistency requirement be modified to permit taxpayers to rely on the foreign basis election as long as they apply the Proposed Regulations consistently to all relevant tax year that remain open.

D. Interaction with Section 909

In our Prior 901(m) Report we noted that transactions, like an acquisition of a reverse hybrid with respect to which a section 338 election is made, can qualify both as a CAA and as a "foreign tax credit splitting event" under section 909. At the time of our Prior 901(m) Report, the IRS had requested comments on whether a CAA should always be treated as a "foreign tax credit splitting event."[70] Since then, Treasury and the IRS studied the interaction of section 901(m) and section 909, including whether to provide taxpayers with an election to apply section 909 in lieu of section 901(m) and/or to treat CAAs as "foreign tax credit splitting events." Ultimately, Treasury and the IRS concluded in the preamble to the final and temporary Treasury regulations under section 909 that applying section 909 to CAAs between related parties would "substantially increase the complexity and administrative burden associated with such transactions,"[71] and decided not to treat CAAs as *per se* "foreign tax credit splitting events." The preamble stated, however, that certain transactions, like the acquisition of a reverse hybrid referred to above, would be both a CAA and a "foreign tax credit splitting event," and that Treasury and the IRS were "considering the extent to which section 909 should apply to suspend deductions for foreign income taxes with respect to which section 901(m) disallows a credit."

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[70] Notice 2010-92, 2010-52 I.R.B. 916.

[71] T.D. 9577, 77 Fed. Reg. 8127 (February 14, 2012).

The preambles to the Temporary Regulations and the Proposed Regulations are silent on the application of section 909 to CAAs. As we noted in our Prior 901(m) Report, we believe that because section 901(m) and section 909 focus on different concerns, as a general matter both section 909 and section 901(m) could appropriately be applied to transactions that fall within the scope of both sections. However, we believe that the administration of both sections would be improved if Treasury Regulations were to establish a clear priority rule, especially in light of the enlarged scope of CAAs under the Proposed Regulations. In addition to reverse hybrids, an increasing number of foreign partnerships will be subject to the Proposed Regulations. Given that foreign partnership arrangements can result in "foreign tax credit splitting events," this may substantially increase the likelihood of overlap transactions. In the absence of a coordination rule addressing the interaction of both these provisions, taxpayers are left to decide for themselves whether to apply the disallowance of a portion of the foreign tax credit under section 901(m) first and then the deferral rules of section 909, or whether to apply the deferral rules first and to perform the section 901(m) calculations only in a subsequent year. Given the complex rules under the Proposed Regulations for calculating the "disallowed foreign tax amount" based on Cost Recovery Amounts and Disposition Amounts allocated to each relevant taxable year after a CAA and the related carryover and successor rules, we believe it would be appropriate to make the calculations required under section 901(m) first and only then to determine whether section 909 requires deferral of the remaining allowed foreign tax credit. We therefore recommend adding an explicit priority rule to the Regulations to the effect that where both section 901(m) and section 909 apply to a given transaction, section 901(m) is applied first.

E. Interaction between the Successor Rules and Subchapter K

If U.S. taxpayers create a foreign partnership and one partner contributes RFAs from a prior CAA to the partnership, there is a Successor Transaction and the unallocated basis

difference in the RFAs remains subject to the Proposed Regulations in the hands of the partnership. It appears that section 901(m) consequences would then apply to all the partners on a going-forward basis. On the one hand, it could be argued that this result is unfair and that the section 901(m) "taint" in the assets should be treated as a built-in item that is allocated back to the contributing partner, under principles similar to those of section 704(c), given the conceptual similarity between built-in gain subject to section 704(c) and the "built-in" basis differential amount attributes being inherited under the successor rule. We understand, however, that addressing this would require adding a section 704(c) overlay to the already highly complex rules of the Proposed Regulations. Moreover, it could be argued that a similar concern arises where unrelated persons contribute assets to a controlled foreign corporation and some of those assets are RFAs as a result of a prior CAA in the hands of one of the contributors or its predecessor. In that case, the Proposed Regulations clearly require all owners to bear their share of the resulting disallowance of U.S. foreign tax credits. It is not obvious that there is a policy rationale specific to section 901(m) to distinguish these cases and to require allocation of the consequences to the non-contributing shareholder. Instead, the result in the corporate example above may be an artifact of entity treatment generally applicable under Subchapter C (and of reluctance to create a complex system of special allocation of the CAA-related attributes in that context).

In the abstract, we believe that applying section 704(c) principles may reach a more appropriate result in the context of Subchapter K. However, we recognize that this raises the policy question whether greater conceptual consistency with the rules of Subchapter K (and the treatment of partnerships as pass-through entities) and the benefit of inflicting the adverse consequences of section 901(m) on the "right" taxpayer outweigh the complexity of adopting a

quasi-704(c) regime for CAA attributes and inconsistent treatment of partnership and corporate transferee situations. We therefore recommend that Treasury and the IRS study the question of whether rules analogous to section 704(c) (including what section 704(c) method(s) would be appropriate) should apply to the allocation of disallowed tax amounts in partnerships and, if justified in principle, whether and how this could be done without making the complex regime set forth in the Proposed Regulations harder to administer.