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Final regulations: Foreign tax credits, and section 901(m) "covered asset acquisitions"

Final regulations under section 901(m) from the U.S. Treasury Department and IRS were published today, March 23, 2020, in the Federal Register.

Read the **"Final Regulations"** [PDF 381 KB]

The Final Regulations adopt, with certain revisions and clarifications (discussed below), the regulations proposed under section 901(m) and section 704(b) (Reg-129128-14) (the Proposed Regulations) in December 2016, together with temporary regulations (T.D. 9800) (the Temporary Regulations). Read [***TaxNewsFlash*** [PDF 54 KB] Dec 6 2016] describing the Proposed Regulations and Temporary Regulations as well as **KPMG's outline** [PDF 64 KB] of the Proposed Regulations and the Temporary Regulations.

Effective date provisions

The Final Regulations are generally effective on March 23, 2020—the date of publication in the Federal Register. However, earlier effective dates apply to various portions of the Final Regulations. For example, certain provisions apply in respect of "covered asset acquisitions" (CAAs) occurring on or after January 1, 2011, when the underlying rule was previously introduced by section 901(m) itself. Other provisions apply in respect of CAAs occurring on or after July 21, 2014, when the provisions contain rules introduced in IRS notices issued in 2014 (described below).

Consistent with the Proposed Regulations, the Final Regulations allow a taxpayer to rely on the regulations prior to their effective date provided that the taxpayer consistently applies all of the regulations to CAAs occurring on or after January 1, 2011 (subject to limited exception). Such reliance may be useful for taxpayers that want to make a "foreign basis election" (described below). See below for a modification of the consistency requirement included in the Final Regulations with respect to tax years which are closed for assessment.

Background

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Section 901(m) was enacted in 2010 and generally limits a taxpayer's ability to claim foreign tax credits associated with a "covered asset acquisition" (CAA). In general, a CAA is an acquisition transaction that results in the creation of additional asset basis for U.S. tax purposes without a corresponding increase in asset basis for foreign tax purposes. The basis "step-up" resulting from a CAA may allow a taxpayer to claim additional depreciation or amortization deductions, thus reducing its earnings and profits for U.S. tax purposes.

Because there is no basis increase for foreign tax purposes, foreign taxable income—and thus foreign taxes—will generally be higher than if the U.S. basis step-up were taken into account in the foreign jurisdiction.

In 2014, the IRS and Treasury issued limited guidance under section 901(m) in the form of Notice 2014-44 (with a clarification later released in Notice 2014-45). Among other things, Notice 2014-44 provided guidance relating to certain dispositions of assets following a section 901(m) CAA including a definition of "disposition," certain successor rules, and stated that future regulations would be issued reflecting this guidance. Read ***TaxNewsFlash*** [PDF 77 KB] and ***TaxNewsFlash*** [PDF 74 KB].

As noted above, Treasury and the IRS issued the Proposed Regulations and the Temporary Regulations in 2016. The Temporary Regulations primarily incorporate guidance provided in Notice 2014-44. The Proposed Regulations provided a more comprehensive set of rules implementing section 901(m), including the adoption of three new classes of transactions that constitute a CAA (with the last of those additional classes being a broad catch-all for any asset transfer which results in a basis increase for U.S. tax purposes without a corresponding basis increase for foreign tax purposes), and were proposed to be effective upon finalization and publication in the Federal Register. However, the Proposed Regulations permitted taxpayers to rely on these rules before their effectiveness subject to consistency requirements.

Final Regulations—Overview

The Final Regulations largely finalize the Proposed Regulations without significant revision. In this regard, the Final Regulations continue to require a very detailed and complex set of rules in their implementation of section 901(m). Further, the Final Regulations maintain the general organization of the Proposed Regulations as outlined in **KPMG's outline** [PDF 64 KB]. For example:

- Reg. section 1.901(m)-1 contains more than 50 defined terms.

- The three new classes of transactions contained in the Proposed Regulations were finalized unchanged. In particular, the Final Regulations retain the broad "catch-all" category that treats any asset acquisition (for both U.S. and foreign income tax purposes) that results in an increase in the U.S. basis without a corresponding increase in the foreign basis as a CAA, despite receiving comments suggesting that this category of CAA was too broad. In response to those comments, Treasury and the IRS stated that section 901(m) is designed to address transactions that result in a basis difference for U.S. and foreign income tax purposes and that there is no intent-based test.

- Under the Final Regulations, tracing of income and taxes to specific assets is not required, and the required computations instead utilize the entire foreign income and foreign tax liability of a foreign taxpayer.

- Despite comments recommending its elimination, the Final Regulations require a taxpayer to maintain an "aggregate basis difference carryover" account. Such account prevents timing differences under U.S. and foreign income tax laws from facilitating the avoidance of the purposes of section 901(m).

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- The election (the Foreign Basis Election) to measure a relevant foreign asset's (RFA's) basis difference arising on account of a CAA by instead comparing U.S. and foreign tax bases immediately after the CAA rather than comparing U.S. tax basis before and after a CAA is retained.

- The de minimis rule was retained (with limited modifications).

- The regulations under section 704(b) providing coordination between 901(m) and the creditable foreign tax expenditure (CFTE) safe harbor rules were finalized without change.

Revisions

While the Final Regulations significantly track to the Proposed Regulations and Temporary Regulations, there are a few features to note:

- **Section 901(m) exception**. As described above, the Final Regulations identify six categories of transactions that constitute CAAs which are consistent with the six categories of transactions identified in the Proposed Regulations. However, in response to comments, Treasury and the IRS added an exception to section 901(m) when a domestic section 901(m) payor or a member of its consolidated group recognized the gains or losses with respect to the relevant foreign assets (RFAs) as part of the original CAA. Such a transaction is not excepted from being treated as a CAA—instead the aggregate basis difference is adjusted to account for the gain or loss recognized by the U.S. consolidated group with respect to the CAA.

Example: USS1 sells a foreign disregarded entity (FDE) to another member of its consolidated group (USS2) in a transaction that is a CAA because it is an asset sale for U.S. income tax purposes and an acquisition of stock of FDE for foreign tax purposes. However, any aggregate basis difference USS2 determines with respect to the RFAs will be adjusted to take into account the gain recognized for U.S. income tax purposes by USS1 on the original sale (provided USS1 and USS2 are still members of the same consolidated group in the year the allocated basis difference is determined).

- **Consistency requirement.** The Proposed Regulations allowed a taxpayer to apply the regulations—including the Foreign Basis Election—before the regulations were finalized, subject to a requirement that the other provisions of the regulations be generally applied with respect to all CAAs occurring on or after January 1, 2011. When applicable, such requirement required the amendment of prior year returns, including with respect to years already closed for assessment. In response to a taxpayer comment, the Final Regulations allow a taxpayer to meet the consistency requirement so long as it adjusts any refund amount to account for deficiencies that would have arisen from the consistent application of the Final Regulations to years closed for assessment.

- **Expansion of de minimis exception.** Comments requested that the thresholds for application of the de minimis exceptions included in the Proposed Regulations be increased (these exceptions applied to a CAA (in the aggregate) or a class of RFAs (in the aggregate) when the aggregate basis differences with respect to such CAA or class, as applicable, did not exceed the specified threshold). The Proposed Regulations contained lower thresholds for related-party transactions. While the generally applicable thresholds were unchanged, the lowering of the thresholds for related-party transactions was eliminated. Further, the Final Regulations provide an additional exception which applies on an asset-by-asset basis. Specifically, a taxpayer is excepted from section 901(m) with respect to an individual RFA when the basis difference with respect to such RFA is less than $20,000.

- **Clarification of the interaction of section 901(m) and section 909.** The Final Regulations made clear that section 909 may apply to foreign taxes that are subject to disqualification under section 901(m). When foreign taxes are disqualified under section 901(m), they generally remain available to be taken by the taxpayer as deductions. Reg. section 1.901(m)-8 provides that section 901(m) is

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to be first applied to any foreign taxes and that the time for taking a deduction with respect to any disqualified foreign taxes resulting from the application of section 901(m) may also be suspended under section 909 when the taxes arise in connection with a "splitter" event.

- **Minor changes in light of TCJA.** Finally, changes were introduced to bring the Proposed Regulations current with changes in U.S. income tax laws introduced by the 2017 tax law (often referred to as the "Tax Cuts and Jobs Act" (TCJA)). Specifically, the term "section 902 corporations" does not apply in respect of tax years beginning after December 31, 2017, and a new defined term ("separate category") was introduced to address the "income groups" delineated by Reg. section 1.960-1 when the relevant taxpayer is a controlled foreign corporation (CFC).

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