§338(G) ELECTION IN THE CROSS-BORDER CONTEXT: I.R.S. TARGETS FOREIGN TAX CREDIT ENHANCER

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INTRODUCTION

The Internal Revenue Code (the "Code") provides a foreign tax credit to relieve U.S. taxpayers from double taxation. Specifically, Code §901 allows a direct credit against U.S. Federal income tax for foreign income taxes paid to another country by a U.S. taxpayer with regard to realized income derived from foreign sources.

Code §901(m) was enacted by the Education Jobs and Medical Assistance Act of 2010 to prevent U.S. taxpayers from benefitting from situations in which the U.S. computation of income differs substantially from the method used in a foreign country due to an election to treat a stock purchase as an asset purchase. Code §338(g) allows a U.S. taxpayer to treat a stock acquisition as an asset acquisition for U.S. tax purposes. By making the election, the premium paid for the shares – the amount by which the purchase price exceeds the book value of the shares – can be pushed down to increase the basis in operating assets of the acquired company. The step-up in depreciable basis of operating assets for U.S. tax purposes results in steeper depreciation and amortization deductions in the U.S. This magnifies the effective tax rate in the foreign country when looked at from a U.S. tax viewpoint, creating mountains of excess foreign tax credits.

EXAMPLE

To illustrate, assume the earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A.") of XCO, a foreign corporation, is 500,000 foreign currency units ("F.C.U.'s") and that the F.C.U. is equal in value to $1.00. If the depreciation deduction for income tax purposes in the foreign country is 50,000 F.C.U.'s, no interest expense exists and no further adjustments are made to arrive the at taxable income. The net income before taxes is 450,000 F.C.U.'s. If the rate of income tax is 30% and no further adjustments are made in computing taxable income, the foreign country income tax is 135,000 F.C.U.'s. At a 34% rate, the U.S. tax is $153,000 before foreign tax credits and $18,000 after foreign tax credits, ignoring allocations and apportionments of shareholder expense to the income.

Now assume that the shares of XCO are acquired for 15 million F.C.U.'s and an election is made for U.S. income tax purposes to treat the share purchase as an asset purchase. Assume further that the share premium is mostly allocated to depreciable assets and that the depreciation deduction is increased for U.S. purposes to 300,000 F.C.U.'s. If the E.B.I.T.D.A. and interest expense remain constant, the taxable income of XCO according to U.S. tax concepts is 200,000 F.C.U.'s. Nonetheless, for foreign tax purposes, the income and tax remain unchanged at 450,000 F.C.U.'s and 135,000 F.C.U.'s, respectively. Consequently, the foreign tax imposed at a constant 30% rate remains 135,000 F.C.U.'s. In comparison, the U.S. tax is reduced to $68,0000 before foreign tax credits and is eliminated entirely by the foreign tax credit. In addition, $67,000 of excess foreign tax credits are available to offset U.S. tax on low-tax foreign-source income.

The foregoing result is viewed to be an unintended double benefit for taxpayers. The reduction in income was not intended to free-up foreign tax credits to offset U.S. tax on other items of foreign-source income. The enactment of Code §901(m) addresses the situation by disallowing a portion of the foreign tax credit generated by the foreign corporation simply because of the increased depreciation deduction (the "Disqualified Tax Amount).[1] While the example focuses on direct foreign tax credits that would exist if foreign operations are carried on as a branch, it does not mean that Code §901(m) applies to the indirect credit that arises from intercompany dividends received by a U.S. parent corporation from its foreign subsidiary.[2] In such cases, neither Code §78 nor Code §275 apply to the Disqualified Tax Amount. The Disqualified Tax Amount is allowed as a deduction to the extent that it is otherwise deductible under U.S. tax law.

PROPOSED REGULATIONS

Overview

On December 6, 2016, the Treasury issued temporary and proposed regulations to clarify rules under Code §901(m). In general, Code §901(m) disallows foreign tax credits on taxes paid or accrued in connection with a "covered assets acquisition" ("C.A.A.").

Definitions

As with many other recent regulations issued by the I.R.S., specific jargon is used throughout. Consequently, before discussing the proposed and temporary regulations, a list of the terms used and their definitions will be helpful. As a convenience, the terminology will be defined a second time throughout the article.

- C.A.A. – a covered asset acquisition, meaning an acquisition that triggers the application of Code §901(m)
- R.F.A. – a relevant foreign asset, meaning an asset that has a lower basis for foreign tax purposes than for U.S. tax purposes, generally because of a C.A.A.
- R.F.A. Owner (U.S.) – the U.S. taxpayer that owns one or more R.F.A.'s and reports the foreign tax credit that is subject to Code §911(m)
- R.F.A. Owner (Foreign) – the foreign taxpayer that owns one or more R.F.A.'s
- Disqualified Tax Amount – the foreign income tax that is no longer creditable because of Code §901(m)
- Multiplicand – the amount of foreign tax that will be reduced by the Disqualified Ratio

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[1] Code §901(m)(6).

[2] Prop. Reg. §1.901(m)(2)(b)(1).

- Disqualified Ratio – a fraction in which the numerator is the sum of the basis difference for all R.F.A.'s for the year and the denominator is the foreign income reflected on the foreign tax return that relates to the Multiplicand
- Aggregate Basis Difference – the numerator of the Disqualified Ratio
- Allocable Foreign Income – the denominator of the Disqualified Ratio
- Allocated Basis Difference – the amount of the basis difference in an R.F.A. that is taken into account in a given U.S. taxable year
- Code §901(m) Payor – the person that is eligible to claim the foreign tax credit and therefore must compute the Disqualified Tax Amount for an R.F.A. arising from a C.A.A.
- Code §902 Corporation – the foreign corporation that has one or more shareholders that are entitled to claim an indirect foreign tax credit under U.S. tax law for the income taxes it pays or accrues
- Foreign Payor – the person that is subject to a foreign income tax and includes a disregarded entity
- F.C.C.T. – the foreign country creditable taxes, meaning income taxes imposed by a third country that reduce income tax in a foreign country
- Disposition Amount – the difference in basis for U.S. and foreign tax purposes
- Unallocated Basis Difference – a difference in basis that has not yet been taken into account under Code §901(m)

Technical Provisions

A C.A.A. is any one of the following four transactions that result in a tax basis for U.S. purposes that is greater than the tax basis for foreign purposes:

- A qualified stock purchase, as defined in Code §338(d)(3)), to which Code §338(a) applies
- A transaction that is treated as an acquisition of assets for U.S. income tax purposes, but is treated as an acquisition of stock of a corporation (or is disregarded) for foreign income taxes purposes – typically, this would be a purchase of shares of a foreign disregarded entity
- An acquisition of an interest in a partnership that has an election in effect under Code §754 to increase its basis in assets when a partnership interest is acquired for a premium that is over net book value
- Any other similar transaction identified by the I.R.S.[3]

To cure the creation of excess foreign tax credits arising from a mismatch of the basis in assets, a portion of the foreign income taxes paid or accrued by the foreign corporation is not taken into account when computing the foreign tax credit. The disregarded portion is the net difference in the bases of all relevant foreign assets ("R.F.A.'s") divided by the income or gain on which the foreign tax is computed.

[3] Code §901(m)(2).

In this manner, the basis differential is allocated to each dollar of income or gain attributable to the R.F.A., and to that extent a percentage of the foreign tax credit is disqualified.

To determine the difference in the bases of the assets, the adjusted basis immediately after C.A.A. is compared with the adjusted bases of those assets immediately before the C.A.A. For this purpose, basis is computed according to U.S. tax concepts. The R.F.A. includes, with respect to foreign income tax arising after the C.A.A., any asset (including goodwill, going concern value, or other intangibles) acquired in the C.A.A. that is relevant in determining foreign income for the purposes of the foreign income tax.[4] The proposed regulations clarify that basis is taken into account even if the asset is not immediately used in determining foreign income.

The proposed regulations provide three additional categories of transactions that may be considered C.A.A.'s.[5] The additions are as follows:

- Purchase of a Disregarded Entity – This includes any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for the purposes of U.S. income tax and as the acquisition of an interest in a fiscally transparent entity for the purposes of foreign income tax.[6]

- Partnership Distributions – This includes any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as a partnership distribution of one or more assets, the U.S. basis of which is determined by Code §§732(b) or 732(d), or which causes the U.S. basis of the partnership's remaining assets to be adjusted under Code §734(b), provided the transaction results in an increase in the U.S. basis of one or more of the assets distributed by the partnership or retained by the partnership without a corresponding increase in the foreign basis of such assets.[7]

- Asset Acquisitions – This includes any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for the purposes of both U.S. income tax and foreign income tax, provided the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets.[8] An example would be a transfer of property to a subsidiary that results in gain recognition for U.S. tax purposes but is entirely tax free. Disqualified preferred shares are issued as part of the consideration in the transfer. In the U.S., the basis is stepped up to reflect the recognized gain of the transfer. Because the tax law in the foreign country has no counterpart to Code §351(g), no gain is recognized and a carryover basis continues to apply to the assets.

After a C.A.A., an asset will become an R.F.A. with respect to foreign income tax if, pursuant to a plan or series of related transactions for which avoiding the application of Code §901(m) is a principal purpose, an asset that was not relevant in

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4 Code §901(m)(4); Prop. Reg. §1.901(m)-2(c)(1).

5 Prop. Reg. §1.901(m)-2(b).

6 Prop. Reg. §1.901(m)-2(b)(4).

7 Prop. Reg. §1.901(m)-2(b)(5).

8 Prop. Reg. §1.901(m)-2(b)(6).

determining the foreign income for the purposes of that foreign income tax becomes relevant immediately following the C.A.A. Moreover, a tainted principal purpose will be deemed to exist if income, deduction, gain, or loss attributable to the asset is taken into account in determining the foreign income within the one-year period following the C.A.A. To illustrate a series of transactions occurring pursuant to a plan, the proposed regulations describe a purely domestic acquisition of shares to which a Code §338(a) election is made that is followed by a drop-down of the of the property owned by the target to its foreign subsidiary where all steps occur within a single taxable year.[9] The initial domestic acquisition is a C.A.A., but the assets are not considered to be R.F.A.'s until the drop-down when the assets are taken into account in computing the foreign tax of the foreign subsidiary.

"A Disqualified Tax Amount is computed separately for each foreign tax return that takes into account income, gain, deduction, or loss from one or more R.F.A.'s in computing the foreign taxable income."

COMPUTING THE DISQUALIFIED TAX AMOUNT[10]

In general, a Disqualified Tax Amount is computed separately for each foreign tax return that takes into account income, gain, deduction, or loss from one or more R.F.A.'s in computing the foreign taxable income. It also applies for each Code §901(m) Payor that pays or accrues, or that is considered to pay or accrue, a portion of the foreign income taxes reflected on the foreign tax return. If the foreign income taxes relate to more than one separate category of income (*i.e.*, general basket or passive), then a separate computation is required for each such category. Members of a U.S.-affiliated group of corporations that file a consolidated return are each treated as a separate Code §901(m) Payors; therefore, Disqualified Tax Amounts are computed at the member level.

The proposed regulations refer to the total taxable income (or loss) that is computed under foreign law for a foreign taxable year and reflected on a foreign tax return as "foreign income," and to the total amount of tax reflected on a foreign tax return as the "foreign income tax amount." Thus, foreign income does not include income that is exempt from foreign income tax. The proposed regulations use the term Foreign Country Creditable Taxes ("F.C.C.T.'s") to refer to any foreign income tax imposed by a third country that is allowed as a credit to reduce the foreign income tax amount in the country of residence of the Code §901(m) Payor.

The Disqualified Tax Amount is the lesser of (i) the tentative Disqualified Tax Amount and (ii) the foreign income tax amount paid or accrued by the Code §901(m) Payor. The tentative Disqualified Tax Amount is determined using a modified version of the formula provided in Code §901(m)(3). The foreign income tax amount paid or accrued by the Code §901(m) Payor (the "Multiplicand") is multiplied by a ratio ("disqualified ratio"). The numerator of the ratio is the sum of the basis differences for all R.F.A.'s that are taken into account and assigned to the U.S. taxable year. The denominator of the ratio is the portion of the foreign income reflected on the foreign tax return that relates to the foreign income tax amount included in the Multiplicand. The numerator and the denominator of the disqualified ratio are referred to in the proposed regulations as the "aggregate basis difference" and "allocable foreign income," respectively.

Allocable foreign income (the denominator of the disqualified ratio) and the foreign income tax amount (the Multiplicand) are determined using the total amount of

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9 Prop. Reg. §1.901(m)-2(e), *Example (3).*

10 Prop. Reg. §1.901(m)-3.

foreign income and the foreign income tax amount reflected on the foreign income tax return instead of by reference only to the amounts determined with respect to the R.F.A.'s. The I.R.S. determined that this approach carries out the purposes of Code §901(m) while avoiding the administrative and compliance burdens that would result from a requirement to trace amounts of income to R.F.A.'s and identify the portion of foreign income tax imposed on that income.

When the numerator and denominator are both positive amounts, the Aggregate Basis Difference included in the numerator is limited to the amount of foreign income in the denominator of the disqualified ratio. This limitation ensures that the computations do not produce a Disqualified Tax Amount that exceeds the foreign income taxes paid or accrued.

When the entire foreign income tax amount reflected on a foreign tax return is paid or accrued by a single Code §901(m) Payor, the Allocable Foreign Income is simply the total foreign income reflected on the foreign tax return. When the foreign income tax amount is allocated to more than one person, the Allocable Foreign Income in the denominator will be allocated among the Code §901(m) Payors in proportion to the allocation of the foreign taxes among those Payors. Guidance is provided for making the allocation of foreign income in three types of cases:[11]

- The foreign income tax amount is allocated because of a mid-year transaction, such as a transfer of a disregarded entity or a Code §338 transaction. Principles set forth in Treas. Reg. §1.1502-76(b), involving part-year members of an affiliated group of corporations filing a consolidated tax return, apply.
- The foreign income tax amount is allocated among the partners of a partnership or a disregarded entity owned by a partnership. Principles set forth in Treas. Reg. §1.704-1(b)(4)(viii), involving allocations of creditable income taxes among the partners of a partnership, apply.
- The foreign income tax amount is allocated among members of a group whose income is taxed on a combined basis for foreign income tax purposes. Principles set forth in Treas. Reg. §1.901-2(f)(3)(iii), involving members of a foreign group benefitting from group relief, apply.

DETERMINING THE BASIS DIFFERENCE FOR AN R.F.A.[12]

Under the temporary regulations, the basis difference is equal to the U.S. basis in the R.F.A. immediately after the C.A.A., less the U.S. basis in the R.F.A. immediately before the C.A.A. Basis difference is an attribute that attaches to an R.F.A.[13] However, the proposed regulations provide for an election ("Foreign Basis Election") to use the basis under foreign law immediately after the C.A.A.[14] For this purpose, the foreign basis immediately after the C.A.A. takes into account any adjustment to that foreign basis resulting from the C.A.A. for the purposes of the foreign income tax. A

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11 Prop. Reg. §1.901(m)-3(b)(2)(iii)(C).

12 Prop. Reg. §1.901(m)-4.

13 Treas. Reg. §1.901(m)-4T(b).

14 Prop. Reg. §1.901(m)-4(c)(1).

Foreign Basis Election is made by using a foreign basis to determine the basis difference for the purposes of computing a Disqualified Tax Amount and an Aggregate Basis Difference carryover for the U.S. taxable year.[15]

The proposed regulations adopt certain terminology that is used in computing the disqualified foreign tax:

- The "R.F.A. Owner (U.S.)" is the person that owns one or more R.F.A.'s for U.S. income tax purposes and therefore is required to report, or otherwise track, items of income, deduction, gain, or loss attributable to the R.F.A.'s for the purposes of computing U.S. taxable income.
- The "R.F.A. Owner (Foreign)" is the person (including a disregarded entity) that owns one or more R.F.A.'s for the purposes of a foreign income tax and therefore generally would report, or otherwise track, items of income, deduction, gain, or loss attributable to the R.F.A.'s for the purposes of determining the income to be reported on a foreign income tax return.

Except as otherwise provided, a Foreign Basis Election is made by the R.F.A. Owner (U.S.). If, however, the R.F.A. Owner (U.S.) is a partnership, each partner in the partnership – and not the partnership, itself – may independently make a Foreign Basis Election. In the case of one or more tiered partnerships, the Foreign Basis Election is made at the level at which a partner is not also a partnership.

The election generally must be reflected on a timely-filed original Federal income tax return for the first U.S. taxable year that the Foreign Basis Election is relevant. An exception to this requirement is provided where the R.F.A. Owner (U.S.) is a partnership.[16] This exception generally provides relief when one or more of the partners and the partnership have agreed that the partnership would provide the partners with the information necessary to apply the basis under foreign tax law, but when the partner timely-filed its tax return, it failed to report the application of Code §901(m). The relief allows the partner to file an amended return using the basis under foreign tax law. Safeguards are provided that are intended to prevent partners from gaming the system through an intentional failure to address Code §901(m).

BASIS DIFFERENCE TAKEN INTO ACCOUNT

The proposed regulations provide rules for determining the amount of basis difference with respect to an R.F.A. that is taken into account in a given U.S. taxable year (referred to in the regulations as "Allocated Basis Difference").[17] The Allocated Basis Difference is used to compute the Disqualified Tax Amount for the U.S. taxable year. Basis difference is taken into account in two ways: under an applicable cost recovery method, or as a result of a disposition of the R.F.A.[18]

An applicable cost recovery method includes any method for recovering the cost of property over time for U.S. income tax purposes.[19] Examples are depreciation,

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15 Prop. Reg. §1.901(m)-4(c)(4).

16 Prop. Reg. §1.901(m)-4(c)(5).

17 Prop. Reg. §1.901(m)-5.

18 *Id.*

19 Prop. Reg. §1.901(m)-5(b)(3).

amortization, or depletion, as well as any method that allows the cost of property to be expensed in the year of acquisition or in the placed-in-service year, such as under Code §179. Applicable cost recovery methods do not include any provision allowing for the recovery of U.S. basis upon a disposition of an R.F.A.

Attributing or Allocating a Cost Recovery Amount to a Code §901(m) Payor

The applicable cost recovery method varies depending on the status of the R.F.A. Owner.

- When the R.F.A. Owner (U.S.) is a Code §901(m) Payor, the entire cost recovery amount is attributed to the Payor and assigned to the U.S. taxable year of the Payor in which the corresponding U.S. basis deduction is taken into account under the applicable cost recovery method.
- When the R.F.A. Owner (U.S.) is a Code §901(m) Payor, the entire disposition amount is generally attributed to the Payor and assigned to the U.S. taxable year of the Payor in which the disposition occurs.
- When the R.F.A. Owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes in which a Code §901(m) Payor directly or indirectly owns an interest, a cost recovery amount must be allocated to the Payor to the extent that the U.S. basis deduction that corresponds to the cost recovery amount is (or will be) included in the Payor's distributive share of the income of the R.F.A. Owner (U.S.) for U.S. income tax purposes.
- If a Code §901(m) Payor acquires a partnership interest in a C.A.A. that allows for a step-up of basis for the Payor under Code §743(b), and subsequently there is a cost recovery amount or a disposition, all of the cost recovery amount or the disposition amount is allocated to that Payor.
- When a disposition of an R.F.A. occurs in the same foreign taxable year that a Foreign Payor is involved in a mid-year transaction, the portion of the disposition amount that is attributable to foreign disposition gain or foreign disposition loss must be allocated to a Code §901(m) Payor under a formula.

Rules are also provided for R.F.A. Owners that are reverse hybrid entities, which are corporations for U.S. purposes but fiscally transparent for foreign tax purposes.

General Disposition Rules

A disposition for the purposes of Code §901(m) is an event that results in a gain or loss being recognized with respect to an R.F.A. for the purposes of U.S. income tax, foreign income tax, or both. The amount of the basis difference must be determined and taken into account upon the disposition of an R.F.A. (the "Disposition Amount").

If an R.F.A. has a positive basis difference, the Disposition Amount attributable to the foreign disposition gain represents the amount of gain in the years following the C.A.A. that was included in foreign income but not in U.S. taxable income or earnings and profits. Accordingly, to the extent that a foreign disposition gain is taken into account in computing a foreign income tax amount, a portion of that foreign income tax amount should be disallowed as a foreign tax credit under Code §901(m).

On the other hand, if an R.F.A. has a negative basis difference and a foreign disposition loss is taken into account in computing the foreign income tax amount, this should reduce the amount of the foreign income tax that otherwise would be disallowed as a foreign tax credit under Code §901(m) as a result of a positive basis difference with respect to one or more other R.F.A.'s. The allocation rules vary depending on whether the Disposition Amount is attributable to foreign disposition gain or loss or U.S. disposition gain or loss.

If a disposition of an R.F.A. is fully taxable for U.S. and foreign income tax purposes, the Disposition Amount will be any remaining unallocated basis difference, whether positive or negative.[20] If a disposition of an R.F.A. is not fully taxable for U.S. and foreign income tax purposes and the R.F.A. has a positive basis difference, the Disposition Amount is based solely on the amount, if any, of foreign disposition gain and U.S. disposition loss. If, on the other hand, a disposition of an R.F.A. is not fully taxable for both U.S. and foreign income tax purposes and the R.F.A. has a negative basis difference, the temporary regulations provide that the Disposition Amount is based solely on the amount, if any, of foreign disposition loss and U.S. disposition gain.

Status of R.F.A. Owner

Like the applicable cost recovery method, the general disposition rules vary depending on the status of the R.F.A. Owner.

When the R.F.A. Owner (U.S.) is a Code §901(m) Payor, the entire Disposition Amount is attributed to the Payor and assigned to the U.S. taxable year in which the disposition occurs.[21]

For U.S. income tax purposes, when the R.F.A. Owner (U.S.) is a fiscally transparent entity in which a Code §901(m) Payor directly or indirectly owns an interest, all or a portion of the Disposition Amount is allocated to the Payor and assigned to its U.S. taxable year.[22] Separate rules apply for identifying the extent to which a foreign disposition gain or loss is taken into account in computing the foreign income tax amount that is paid or accrued by a Code §901(m) Payor in the context of an R.F.A. Owner (U.S.) that is a fiscally transparent.

"Like the applicable cost recovery method, the general disposition rules vary depending on the status of the R.F.A. Owner."

The first rule[23] applies when the foreign income tax amount is not allocated. This occurs when the foreign payor is the Code §901(m) Payor. A portion of the Disposition Amount attributable to foreign disposition gain or loss is allocated to the Code §901(m) Payor proportionally to the amount of the foreign disposition gain or loss that is included in the foreign Payor's distributive share of the foreign income of the R.F.A. Owner (Foreign) for foreign income tax purposes.

The second rule[24] applies when the foreign income tax amount is allocated under Reg. §1.704-1(b)(4)(viii) because, for U.S. tax purposes, the foreign payor is a partnership in which the Code §901(m) Payor is a partner. Here, a portion of the Disposition Amount attributable to foreign disposition gain or loss is allocated to the Code §901(m) Payor proportionally to the amount of the foreign disposition gain or loss that is included in the allocable foreign income of the Code §901(m) Payor.

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20 Prop. Reg. §1.901(m)-5T(c)(2)(i).

21 Prop. Reg. §1.901(m)-5(c)(1).

22 Prop. Reg. §1.901(m)-5(d).

23 Prop. Reg. §1.901(m)-5(d)(3)(ii).

24 Prop. Reg. §1.901(m)-5(d)(3)(iii).

Allocation of Disposition Amount

Where a Disposition Amount is attributable to U.S. disposition gain or loss, the Disposition Amount is allocated to the Code §901(m) Payor based on the portion of the U.S. disposition gain or loss determined at the level of the R.F.A. Owner (U.S.) that is includible in the Code §901(m) Payor's distributive share of the income of the R.F.A. Owner (U.S.).[25]

When an R.F.A. has a positive basis difference, a Disposition Amount arises from a disposition of the R.F.A. only if the disposition results in a foreign disposition gain or a U.S. disposition loss. Here, it is necessary to determine the extent to which the Disposition Amount is attributable to foreign disposition gain or U.S. disposition loss. If the disposition results in either a foreign disposition gain or a U.S. disposition loss, but not both, the entire Disposition Amount is attributable to one or the other in its entirely.[26] If the disposition results in both a foreign disposition gain and a U.S. disposition loss, the Disposition Amount is attributable first to the foreign disposition gain and then any excess Disposition Amount is attributable to the U.S. disposition loss. In the case of a disposition that is fully taxable for both U.S. and foreign income tax purposes, the Disposition Amount may exceed the sum of the foreign disposition gain and the absolute value of the U.S. disposition loss if, immediately before the C.A.A., the foreign basis in the R.F.A. was greater than the U.S basis, and a foreign basis election was not made.

When an R.F.A. has a negative basis difference, a Disposition Amount arises from a disposition of the R.F.A. only if the disposition results in a foreign disposition loss or a U.S. disposition gain. In allocating the Disposition Amount to a Code §901(m) Payor, the extent to which the Disposition Amount is attributable to foreign disposition loss or U.S. disposition gain must be determined.

Special rules allocate a Disposition Amount attributable to foreign disposition gain or foreign disposition loss to a Code §901(m) Payor and assign it to its U.S. taxable year under any of the following conditions:

- There is a step-up of basis for the Payor under Code §743(b). The Disposition Amount that arises from an R.F.A. with respect to that C.A.A. must be allocated to the acquiring Code §901(m) Payor.[27]
- There is a mid-year transaction. The allocation of the Disposition Amount under the principles of Treas. Reg. §1.1502-76(b) will be made to the persons involved in the mid-year transaction.[28]
- The R.F.A. Owner (U.S.) is either a reverse hybrid or a fiscally transparent entity for U.S. and foreign income tax purposes that is directly or indirectly owned by a reverse hybrid entity. The principles are similar to those for when an R.F.A. Owner (U.S.) is a fiscally transparent entity for U.S. income tax purposes.[29] The Disposition Amount should be allocated to the Code §901(m) Payor proportionally to the amount of the foreign income of the R.F.A. Owner

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25 Prop. Reg. §1.901(m)-5(d)(4).

26 Prop. Reg. §1.901(m)-5(d)(5)(i).

27 Prop. Reg. §1.901(m)-5(e).

28 Prop. Reg. §1.901(m)-5(f).

29 Prop. Reg. §1.901(m)-5(g).

(Foreign) that is taken into account in computing the foreign payor's foreign income tax amount that is paid or accrued by the Code §901(m) Payor.

SUCCESSOR, *DE MINIMIS*, & MISCELLANEOUS RULES

Successor rules[30] are provided for the application of Code §901(m) to subsequent transfers of R.F.A.'s that have an Unallocated Basis Difference. This occurs when differences in basis have not been fully taken into account at the time of a transfer. For U.S. income tax purposes, Code §901(m) continues to apply to an R.F.A. after it has been transferred if the R.F.A. continues to have an Unallocated Basis Difference following the transfer.

De minimis rules are provided under which certain basis differences are not taken into account under Code §901(m).[31] A basis difference with respect to an R.F.A. is not taken into account for the purposes of Code §901(m) in two circumstances:

- The sum of the basis differences for all R.F.A.'s. with respect to the C.A.A. is less than $10 million, or if greater, 10% of the total U.S. bases of all R.F.A.'s immediately after the C.A.A.
- The R.F.A. is part of a class of R.F.A.'s for which the sum of the basis differences of all R.F.A.'s in the class is less than $2 million, or if greater, 10% of the total U.S. bases of all R.F.A.'s in the class. For this purpose, the classes of R.F.A.'s are the seven asset classes defined in Code §1.338-6(b).

Transactions between related parties are subject to reduced ceilings when applying the *de minimis* exception. For C.A.A.'s involving related parties, the exceptions will apply when the sum of the basis differences for all R.F.A.'s with respect to the C.A.A. is less than $5 million, or if greater, 5% of the total U.S. bases of all R.F.A.'s immediately after the C.A.A. In addition, when applying the ceiling for R.F.A.'s in the seven asset classes, a fixed ceiling of $1 million is applied for related parties. An anti-abuse provision also denies the application of the *de minimis* exemptions to C.A.A.'s between related parties that are entered into or structured with a principal purpose of avoiding the application of Code §901(m).

When effective, both the temporary regulations and the proposed regulations will generally relate back to the effective date of Notices 2014-44 and 2014-45. In some circumstances, the temporary and proposed regulations will apply to transactions occurring after January 1, 2011.

CONCLUSION

Code §901(m) and the temporary and proposed regulations issued by the I.R.S. evidence a recent trend in tax legislation and regulations. They close a perceived loophole in tax law by adopting a standalone set of rules that are relatively complex and have little relation to general concepts of U.S. tax law. Those practitioners who delve into the area without an in-depth understanding of the transactions that have been targeted by Congress due so at their own peril.

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30 Prop. Reg. §1.901(m)-6.

31 Prop. Reg. §1.901(m)-7.