NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 901(m)

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Section 901(m): Covered Asset Acquisitions[1]

This report offers suggestions for administrative guidance under Section 901(m), enacted in August of 2010.[2] As described below, Section 901(m) generally disallows foreign tax credits in cases where a "covered asset acquisition" ("CAA") results in the creation of additional asset basis for U.S. tax purposes, without a corresponding increase in the basis of such assets for foreign tax purposes. Although there is little legislative history for the statute, it appears that Congress enacted Section 901(m) to address concerns that when a CAA occurs, a U.S. taxpayer can exploit the disparity between assets' U.S. tax basis and their foreign tax basis in order to receive foreign tax credits with respect to income that is never included in the U.S. tax base. In effect, the taxpayer is artificially increasing the effective foreign tax rate relative to the taxpayer's income as determined under U.S. tax principles.

Part I of this report discusses further the apparent purpose of Section 901(m) and describes how the statute operates, as well as discussing some key issues that the Government and taxpayers will face when applying the statute. Part II summarizes our recommendations for guidance. Part III discusses issues related to the definition of a CAA. Part IV analyzes other issues arising under Section 901(m).

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2 Unless otherwise indicated, all references in this report to "Section" and "Sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" are to regulations issued thereunder (the "Treasury Regulations" or "Regulations"). References to the "IRS" are to the Internal Revenue Service, and references to "Treasury" are to the United States Department of the Treasury.

I. Overview of Section 901(m)

A. Background and Legislative History

U.S. citizens and residents and U.S. corporations generally are subject to federal income tax on their worldwide income, regardless of its source. The foreign tax credit regime is meant to mitigate the double taxation that would result if a U.S. person's foreign-source income were taxed both by the source country and by the United States.[3] In effect, by granting a foreign tax credit, the United States cedes primary taxing jurisdiction over such income to the source country.

The Code sections and Treasury Regulations that implement the foreign tax credit regime reflect an awareness that, because the Code differs significantly from the income tax laws of many foreign countries, there may be differences between a taxpayer's taxable income as computed under U.S. principles and as computed under the applicable foreign country's laws. The Code and Treasury Regulations provide guidance as to how such differences are to be addressed when computing the foreign tax credit.[4]

Congress apparently intended Section 901(m) to prevent taxpayers from exploiting certain transactions that give rise to a permanent difference between the taxpayers' U.S. taxable base and foreign taxable base, in a manner inconsistent with the basic purposes of the foreign tax credit system. The legislation that enacted Section 901(m) was introduced in the spring of 2010, as an

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3 See American Chicle Co. v. U.S., 316 U.S. 450 (1942); Burnet v. Chicago Portrait Co., 285 U.S. 1 (1932).

4 See Section 904(d)(2)(H); Treas. Reg. § 1.904-6(a)(1)(iv). In general, taxpayers are entitled to claim a credit for foreign tax imposed on items of income that are permanently excluded from the U.S. taxable base. A taxpayer's credit for such a tax normally falls into the general category income basket in Section 904. By comparison, where a foreign tax is imposed on an item of income that would be included in the U.S. taxable base in a different year, a taxpayer is generally entitled to claim a credit in the year the tax is paid or accrued, and the credit falls into the same basket under Section 904 as it would if the applicable income were recognized for U.S. tax purposes in the same year as the foreign tax is imposed.

amendment to a bill that extended expiring tax benefits.[5] No proposal corresponding to Section 901(m) had previously been included in the Treasury Department's "Green Book" for 2010 or 2011. In addition, Congress provided little explanation of, or opportunity for review and comment on, the new provision before it was enacted. Based on the limited legislative history available, the specific concerns that Section 901(m) was intended to address appear to be as follows.[6]

When a U.S. person acquires equity of a foreign entity, the Code and Treasury Regulations provide for a number of elections that (when available) permit the acquirer to treat the transaction as an asset purchase for U.S. tax purposes. These elections generally have no counterpart under foreign countries' tax laws, with the result that the acquirer can obtain a "step-up" in the basis of the acquired entity's assets for U.S. tax purposes without any matching step-up for foreign tax purposes. Accordingly, when the acquired entity earns income in periods following the acquisition, it generally will be the case that a larger amount of depreciation and amortization expense is available to offset that income for U.S. tax purposes than is available for foreign tax purposes, and that a smaller amount of gain (or larger loss) is recognized for U.S. tax purposes than for foreign tax purposes when the assets are sold. Thus, the entity's U.S. owner will generally pay U.S. tax on an amount of net income from the entity that is smaller than the amount of the entity's net income that is subjected to foreign income tax. (If the entity is a disregarded entity or a partnership for U.S. tax purposes, this result will occur on a current basis, as income flows through to the U.S. owner; if the entity is a corporation for U.S. tax purposes, this result will occur when the U.S. owner receives taxable

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5 See Tax Extenders Act of 2009, H.R. 4213, 111th Congr. (2009); American Workers, State, and Business Relief Act of 2010, H.R. 4213, 111th Congr. (2010); Small Business and Infrastructure Jobs Tax Act of 2010, H.R. 4849, 111th Congr. (2010).

6 See Joint Comm. 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) (Aug. 10, 2010) at 10-13 (the "JCT Report").

dividends (or Subpart F income) in amounts that are reduced as a result of the entity having lower earnings & profits ("E&P").)

In such circumstances, the U.S. owner potentially can claim a credit under the Code for foreign tax that is imposed on income of the entity which will not be subject to U.S. tax in the owner's hands (due to the extra depreciation and amortization that results from the step-up in the U.S. tax basis of the entity's assets). In effect, the U.S. owner is artificially increasing the effective rate of creditable foreign tax on income as computed under U.S. tax principles. If the creditable foreign tax exceeds the amount of U.S. tax that is due on such income, then the U.S. owner could use some of the credits associated with that foreign tax to shelter other, unrelated income from U.S. tax. The U.S. owner will have achieved these results without having to suffer any foreign tax costs or complexities in order to do so – the U.S. tax election that the owner has made has no foreign tax consequences. The Joint Committee on Taxation's technical explanation of the bill that contained Section 901(m), as well as statements by the sponsors of a contemporaneous, identically worded legislative proposal, suggest that Congress enacted Section 901(m) in order to prevent this outcome.[7]

B. Definition of a CAA

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[7] See JCT Report at 12-13 (noting that the step-up in U.S. tax basis resulting from a Section 338 election, a Section 754 election, or a "check-the-box" election for an acquired foreign entity generally gives rise to "a permanent difference between (1) the foreign taxable income upon which foreign tax is levied, and (2) the U.S. taxable income (or E&P) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed."). Similarly, Rep. Sander Levin and Senator Max Baucus co-sponsored a bill a few months before Section 901(m) was enacted, which contained proposed legislation worded identically to Section 901(m) (H.R. 4213, 111th Congr. (2010), "The American Jobs and Closing Tax Loopholes Act of 2010," introduced May 20, 2010). The summary that their staffs prepared of the bill states that in the case of a CAA, a step-up in asset basis "usually exists only for U.S. tax purposes, and not for foreign tax purposes. As a result, depreciation for U.S. tax purposes exceeds depreciation for foreign tax purposes, such that the U.S. taxable base is lower than the foreign taxable base. Because foreign taxes – and therefore foreign tax credits – are based on the foreign taxable base, there are more foreign tax credits than necessary to avoid double tax on the U.S. tax base. Taxpayers are using these additional foreign tax credits to reduce taxes imposed on other, completely unrelated foreign income. The bill would prevent taxpayers from claiming the foreign tax credit with respect to foreign income that is never subject to U.S. taxation because of a covered asset acquisition." See Ways and Means Comm., "The American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, May 20, 2010" (2010 Tax Notes Today 98-33) (May 20, 2010) at 21 ("Tax Loopholes Act Summary").

A CAA is defined in Section 901(m) to include: (i) a qualified stock purchase to which Section 338(a) applies; (ii) any transaction which is treated as an acquisition of assets for U.S. tax purposes but is either (a) treated as an acquisition of stock or (b) disregarded for purposes of foreign income taxes of the relevant jurisdiction; (iii) any acquisition of an interest in a partnership which has a Section 754 election in effect; and (iv) any "similar transaction," as specified by the Secretary of the Treasury.[8] In general, the transactions described in (i) through (iii) have the legal form of acquisitions of an entity's shares, while being treated for U.S. tax purposes as acquisitions of assets held by that entity as a result of an election made for U.S. tax purposes. Such elections generally have no impact under foreign tax law, with the result that the tax basis of the entity's assets for foreign tax purposes is not adjusted to fair market value at the time of the transaction. Consistent with this basic pattern, the JCT Report states that "It is 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."[9]

C. Consequences of a CAA

Section 901(m)(1) provides that when a CAA has occurred, the "disqualified portion" of any foreign income tax determined with respect to income or gain attributable to that CAA is not creditable for purposes of Sections 901, 902, and 960. The disqualified portion of such foreign income tax in any particular year is equal to the amount of such tax, multiplied by a fraction: the

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

[9] JCT Report at 14.

numerator of the fraction is the "aggregate basis differences" allocable to that year, and the denominator is the income on which such foreign income tax is determined.[10]

Section 901(m)(3)(C) defines "basis difference" to mean, for each relevant asset with respect to the CAA, the excess of (i) the adjusted tax basis of that asset for U.S. federal income tax purposes immediately after the CAA, over (ii) the adjusted tax basis of that asset for U.S. federal income tax purposes immediately before the CAA. If the relevant asset's basis immediately after the transaction is less than its basis immediately beforehand, then the basis difference is a negative number.[11] Each asset's basis difference (whether positive or negative) is allocated to taxable years using the cost recovery method that is generally applicable to that asset for U.S. federal income tax purposes.[12] However, if there is a "disposition" of an asset, the portion of that asset's basis difference that has not yet been allocated as of the time of the disposition, is all allocated to the year of the disposition.[13] For each taxable year, the "aggregate basis differences" allocable to that year equal the sum of the positive and negative basis differences for each relevant asset that are allocated to that year under the rules just described.[14] However, the aggregate basis differences for any year cannot be less than zero.[15]

Section 901(m) permits a taxpayer to claim a deduction for foreign taxes for which a credit is denied, even if the taxpayer otherwise elects to claim a credit for foreign taxes.[16] In addition, Section

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10 The JCT Report states that, for purposes of computing the denominator, "the income on which the foreign income tax is determined is the income as determined under the law of the relevant jurisdiction." JCT Report at 14.

11 Section 901(m)(3)(C)(ii).

12 Section 901(m)(3)(B)(i).

13 Section 901(m)(3)(B)(ii).

14 Section 901(m)(3)(A)(i).

15 Id.

16 Section 901(m)(6).

901(m) does not prohibit a foreign corporation from reducing its E&P by the amount of a foreign tax for which Section 901(m) denies a credit.

D. Basic Issues Raised by Section 901(m)

As noted above, Congress enacted Section 901(m) quickly, with little opportunity for review or comment. In our view, the statute reflects a number of significant flaws, perhaps as a result of the speed with which it was drafted.

1. Even though Congress apparently meant to focus on transactions in which there is a step-up in the U.S. tax basis of assets without a corresponding step-up in the assets' basis for foreign tax purposes, Section 901(m) does not exclude from the definition of CAA a transaction in which there is a step-up in asset basis for foreign tax purposes.

2. The statute contains an awkwardly constructed formula for computing the amount of foreign tax credits that are disallowed as a result of a CAA. Section 901(m)(3) states that the acquiring taxpayer must measure its "basis differences" by looking to the difference between the U.S. tax basis of the acquired assets immediately before, and immediately after, the CAA. The amount of foreign tax credits disallowed is determined based on the size of these basis differences. However, the legislative history of the statute, as well as certain features of the language of the statute, suggest that it often would be reasonable to look to the difference between the acquired assets' basis for foreign tax purposes, and the assets' post-acquisition basis as determined for U.S. tax purposes, in order to determine the amount of foreign tax credits that should be disallowed. Depending on the facts of a particular transaction, and one's view of the exact intent behind Section 901(m), each of these two alternatives appears to work well in some cases but not in others.

In addition, as a practical matter, if taxpayers are required to determine an acquired foreign entity's U.S. tax basis in its assets as of the time immediately prior to a CAA, in order to apply Section 901(m), this often will deprive taxpayers of one of the main practical benefits that would lead them to structure an acquisition as a CAA in the first place: the ability to avoid the significant time and cost associated with determining the entity's U.S. tax "history" (including its historic basis in its assets) in periods prior to the acquisition.

It should be noted that, instead of adopting the approach chosen in Section 901(m), Congress could have responded to CAAs by requiring U.S. taxpayers to place foreign tax credits from each such transaction in a separate basket under Section 904. Such an approach would have eliminated concerns about cross-crediting of foreign tax credits from such transactions. It would not have eliminated the result of a higher effective foreign tax rate being imposed on income generated by the assets that are acquired in a CAA; but such a system would have been significantly easier to administer than Section 901(m). Particularly in cases where the income generated by the assets in question was already subject to a high effective foreign tax rate even in the absence of the CAA, such an approach might have been preferable to Section 901(m). However, it appears that Congress deliberately chose to address its concerns in a different manner.

3. Even though Section 901(m) in theory serves to disallow credits for foreign tax attributable to income generated by the assets acquired in a CAA, in practice it often will be difficult or impossible to identify the relevant amount of foreign tax and related income, because foreign tax will be computed on a base that also includes unrelated income generated by assets not acquired in the CAA.

In view of these difficulties, we believe it is advisable that Treasury exercise the regulatory authority granted to it under Section 901(m) to provide that only a carefully limited class of transactions will be treated as CAAs. We also believe it is advisable that flexible rules be adopted for determining how the statute should be applied to a transaction that is a CAA, in an effort to mitigate the significant potential burdens that the statute creates for taxpayers (and the IRS).

II. Summary of Recommendations

Our principal recommendations are that Treasury and the Internal Revenue Service:

1. Issue guidance providing that a transaction is a CAA only if it results in a step-up in the basis of acquired assets for U.S. tax purposes but not for foreign tax purposes.

2. Issue guidance addressing the question of whether a transaction should be a CAA if the seller recognizes gain that is subject to U.S. tax.

3. Not identify any transaction involving an actual transfer of legal ownership of assets from one party to another as a CAA in guidance under Section 901(m)(2)(D). In the event that Treasury and the Service reject this recommendation, we urge that guidance be issued that carefully and clearly identifies limited categories of asset transfers as CAAs, while leaving most asset transfers outside the scope of the statute.

4. Issue guidance to provide a useful de minimis exception to the definition of a CAA. We recommend that, among other rules, such guidance provide that if assets have been acquired shortly before a transaction that is being tested for CAA status, and the acquirer has taken a stepped-up foreign tax basis in the acquired assets, then the transaction should not be a CAA.

5. Provide guidance as to when a transaction is divided into multiple CAAs, rather than being treated as a single CAA. In general, it would be appropriate to provide that when a taxpayer acquires an entity with branches in multiple countries, there is a separate CAA for each one of those

branches. In addition, if multiple entities are acquired in a single transaction, it would normally be appropriate to treat the transaction as a separate CAA with respect to each acquired entity, subject to limited exceptions. This is true regardless of whether the acquired entities are regarded or disregarded entities for U.S. tax purposes.

6. Provide guidance about how to determine "the income or gain attributable to the relevant foreign assets" that have been acquired in a CAA, for purposes of Section 901(m)(1). Such guidance should provide for a practical approach in a case where an entity acquired in a CAA later acquires additional assets in transactions unrelated to the CAA.

7. Provide that taxpayers can elect to compute basis differences under Section 901(m)(3) by reference to the difference between the acquired assets' basis for U.S. tax purposes immediately after a CAA, and the assets' tax basis for foreign tax purposes at the time of the CAA.

8. Issue guidance providing that when a taxpayer has a net negative basis difference under Section 901(m)(3) in a particular year, that basis difference will be applied to reduce positive basis differences in other years.

9. Clarify the meaning of a "disposition" of an asset acquired in a CAA, for purposes of Section 901(m)(3)(B)(ii). We recommend that a taxpayer be treated as having made a disposition of an asset when the taxpayer transfers the asset and recognizes gain for foreign tax purposes on the transfer. We also recommend that the taxpayer be treated as having made a disposition if the taxpayer transfers the asset and recognizes a loss for U.S. tax purposes on the transfer.

10. Provide guidance explaining how Section 901(m) applies when a series of different taxpayers acquire the same foreign assets over time. In particular, we recommend that such guidance provide that, if a taxpayer acquires assets that were the subject of a previous CAA in a transaction

that does not qualify as a CAA, then the taxpayer "steps into the shoes" of the previous owner for purposes of the Section 901(m) limitation. If a taxpayer acquires assets that were the subject of a previous CAA in a transaction that qualifies as a CAA, then rules are needed to coordinate the Section 901(m) limitations from the previous CAA and the current CAA.

11. Issue guidance clarifying the interaction between Section 901(m) and Section 909, when the same transaction is both a CAA and a "foreign tax credit splitting event." In some cases, it may be appropriate for Section 909 to preempt application of Section 901(m). However, in general we believe that both provisions should be applied in tandem, when a transaction qualifies as both a CAA and a foreign tax credit splitting event. When both provisions are applied in tandem to the same transaction, it would be logical first to apply Section 901(m) to disallow the relevant portion of the foreign tax credits attributable to the acquired business, and then to apply the timing rules of Section 909 to the remaining tax credits.

III. <u>Definition of a CAA</u>

A. Step-Up in Asset Basis for U.S. Tax Purposes but not for Foreign Tax Purposes

Treasury should issue guidance providing that a transaction will be a CAA only if the transaction results in a step-up in the basis of acquired assets for U.S. tax purposes but not for purposes of applicable foreign tax law. This should be the case both for transactions described in Section 901(m)(2)(A) through (C) and for any transactions that are identified as "similar transactions" under Section 901(m)(2)(D).

Such an exclusion would be consistent with Congress' intent in enacting Section 901(m). The JCT Report's repeated observations that elections under Section 338, Section 754 and the "check the box" rules" give rise to increased U.S. tax basis without any corresponding increase in foreign tax basis, as well its remark quoted above about guidance under Section 901(m)(2)(D) ("It is 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."), indicate that Congress intended to limit its focus to transactions that result in a step-up in asset basis for U.S. but not for foreign tax purposes. Congress seems to have had in mind a paradigm like the following:

> <u>Example 1</u>. Seller owns Forco, a foreign corporation that owns (for simplicity) a single asset with a U.S. and foreign tax basis of 0. U.S. Corp buys the shares of Forco for 150 and makes a Section 338 election. The transaction results in no foreign income tax for Forco, and its tax basis in its asset continues to be 0 for foreign income tax purposes. However, for U.S. tax purposes, Forco's basis in its asset is stepped up to 150. Under the Code, for purposes of computing Forco's E&P in post-acquisition periods, Forco's asset can be amortized over a 15-year period using the straight-line method.

In a case like Example 1, Forco's income for purposes of computing its E&P under the Code each year following the transaction will be 10 lower than its income for foreign income tax purposes. If Forco pays foreign tax at a 30% effective rate, this will translate to an extra 3 of foreign income tax for which (in the absence of Section 901(m)) U.S. Corp will be eligible to receive credits under Section 902 or 960. U.S. Corp could use such credits to reduce its U.S. tax liability on dividends, or Subpart F income, that it receives from Forco; or, if U.S. Corp has more than sufficient credits to completely eliminate U.S. federal tax with respect to such dividends or Subpart F income, U.S. Corp could use the credits to eliminate U.S. tax on other, unrelated foreign-source income. U.S. Corp would get these favorable results through the simple expedient of filing a U.S. tax election that has no relevance for foreign tax purposes.

By comparison, if U.S. Corp's acquisition of Forco were treated as an asset purchase for both foreign and U.S. tax purposes, the results would be quite different. In that case, in periods following the acquisition, there generally would be no difference between Forco's pre-tax E&P as computed for U.S. tax purposes, and its taxable income as computed for foreign tax purposes, assuming that the acquired asset was amortizable for foreign as well as U.S. tax purposes. There might be timing differences in such a case, if the 15-year useful life of the asset for U.S. tax purposes was shorter or longer than the asset's useful life for foreign income tax purposes, or if different depreciation methods applied; but ultimately the same amount of depreciation or amortization would be claimed for both U.S. and foreign tax purposes. As a result, the acquisition transaction would not create an increase in the effective foreign tax rate relative to Forco's pre-tax E&P as computed under the Code, in periods after the acquisition. The concerns that led Congress to adopt Section 901(m) would be absent.

Thus, when a transaction results in a step-up of the acquired entity's basis in its assets for foreign as well as U.S. tax purposes, the transaction should not be a CAA. The JCT Report expressly contemplates that regulations will be issued to this effect.[17] This point is a meaningful one because, in some cases, a foreign country's tax rules may permit parties to structure an acquisition of shares of an entity in a manner that will result in an adjustment of the entity's tax basis in its assets to fair market value for foreign income tax purposes.

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[17] See JCT Report at 16 ("The Secretary may issue regulations or other guidance as is necessary or appropriate to carry out the purposes of this provision, including to provide (1) an exemption for certain covered asset acquisitions, and (2) an exemption for relevant foreign assets with respect to which the basis difference is de minimis. For example, it is anticipated that the Secretary will exclude covered asset acquisitions that are not taxable for U.S. tax purposes, *or in which the basis of the relevant foreign assets is also increased for purposes of the tax laws of the relevant jurisdiction.*") (emphasis added).

It should be noted that U.S. acquirers may be induced by Section 901(m) to actually acquire foreign assets, suffering the resulting foreign tax cost on transfer of the assets and transactional complexity associated with an actual asset transfer, in order to avoid the burdens of complying with Section 901(m) and the uncertainties associated with the statute's interpretation (detailed in Part IV below). It is not clear Congress intended to incentivize taxpayers to incur such costs in order to plan out of Section 901(m).

B. Recognition by the Seller of Gain Subject to U.S. Tax

We recommend that Treasury and the Service issue guidance under Section 901(m) addressing whether a sale of a foreign entity that results in a current U.S. tax cost for the seller should qualify as a CAA.

> Example 2. U.S. Parent, the parent of a U.S. consolidated group, sells U.S. Sub, a U.S. corporation that has one or more foreign branches, to Buyer, a corporation. The parties make a Section 338(h)(10) election for U.S. Sub. U.S. Sub's basis in the assets of its foreign branch does not change for foreign tax purposes as a result of the transaction.

In a case like Example 2, arguments can be made on both sides of the question whether Section 901(m) should apply. The argument for excluding such a transaction from the scope of the statute is that, even though Buyer has obtained a step-up in the U.S. tax basis of the assets of U.S. Sub's foreign branch, this step-up has come only with a U.S. tax cost. U.S. Parent will include in its consolidated return taxable gain attributable to the deemed sale of U.S. Sub's assets under Section 338(h)(10). In such a case, even though U.S. Sub's taxable income (as computed for U.S. income tax purposes) from its foreign branch will be reduced in periods after the transaction, and may exceed U.S. Sub's taxable income (as computed for foreign tax purposes) from the branch, these consequences flow directly from U.S. Parent's recognition of gain for U.S. tax purposes. To reduce the amount of foreign tax credits available to U.S. Sub in post-acquisition periods would be, arguably, to impose double U.S. taxation: U.S. tax will be imposed on the buyer by eliminating the credit, even though the full amount of income to which the credit relates has been included in the U.S. taxable base by the seller.[18]

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[18] Similar arguments can be made if U.S. Parent sells a disregarded entity or a partnership with a foreign branch to Buyer, instead of selling a U.S. subsidiary with a Section 338(h)(10) election.

On other hand, arguments also can be made for treating Example 2 as a CAA. In a number of different circumstances, U.S. Parent may be indifferent as to whether its sale of U.S. Sub is treated as an asset sale for U.S. tax purposes, rather than as a stock sale. U.S. Parent's tax basis in the stock of U.S. Sub in many cases may not be very different than the tax basis of U.S. Sub's assets as computed for U.S. tax purposes. A particularly troublesome example of when this might be true, is a case where U.S. Parent has recently acquired the assets held by U.S. Sub in a transaction (perhaps a prior CAA where the seller was a foreign person) that resulted in a step-up in the U.S. tax basis of those assets. In such a case, there would be the potential for real abuse, if U.S. Parent's sale to Buyer was excluded from the definition of a CAA. In addition, even assuming that asset sale treatment results in recognition of a greater amount of gain for U.S. tax purposes than does treatment of the transaction as a stock sale, U.S. Parent nevertheless might have net operating losses or foreign tax credits that it could use to prevent such extra gain from being subjected to U.S. tax, and that U.S. Parent otherwise might have been unable to use. In all of the types of circumstances just described, it may at best be a stretch to say that U.S. Parent has incurred a real U.S. tax cost as a result of the treatment of the transaction as an asset sale for U.S. tax purposes. Instead, one could conclude Buyer has gotten all of the foreign tax credit benefits associated with a step-up in the U.S. tax basis of U.S. Sub's assets, without any meaningful consequences for U.S. Parent.

The difficulties in determining whether the seller has incurred a "real" U.S. tax cost only tend to increase, in cases where a CAA is not treated for U.S. tax purposes as a direct sale of foreign assets by a U.S. seller.

In addition, similar considerations would apply when a U.S. acquirer buys from a foreign seller a foreign entity with a U.S. branch, in a transaction that is described in Section 901(m). In such a case, the assets of the U.S. branch arguably should be excluded from the scope of Section 901(m), even though the target entity may pay foreign income tax in its home country on the income generated by the U.S. branch. This is because full U.S. tax has been paid in such a case on the deemed sale of assets of the U.S. branch.

> Example 3. The facts are the same as in Example 2, except that instead of owning a foreign branch, U.S. Sub owns Foreign Sub, a CFC. The parties make a Section 338(h)(10) election for U.S. Sub and a Section 338(g) election for Foreign Sub.

In Example 3, U.S. Parent will include gain in its U.S. consolidated return that is attributable to the sale of Foreign Sub. This gain, logically, corresponds to appreciation in the underlying assets held by Foreign Sub. Accordingly, there is an argument that the step-up in the U.S. tax basis of Foreign Sub's assets that results from the transaction should be excluded from the CAA regime, at least to the extent that the step-up does not exceed the amount of gain recognized by U.S. Parent on the sale of Foreign Sub.

However, it probably is the case that U.S. Parent would recognize the same overall amount of income or gain in Example 3, regardless of whether a Section 338 election is made for Foreign Sub or not. Although the character of that income or gain may vary (the seller's Section 1248 amount and/or amount of Subpart F income may be greater when a Section 338 election is made with its capital gain being correspondingly reduced), that fact may not be particularly important to U.S. Parent. This is especially so in view of Section 338(h)(16), which is (imperfectly) designed to leave the seller in the same foreign tax credit position notwithstanding such a difference in character. Thus, there is reason for concluding that U.S. Parent often will have no extra U.S. tax cost as a result of the parties' decision to make a Section 338 election for Foreign Sub in Example 3; rather, it can be argued that the decision to make the election normally will result in U.S. tax benefits for Buyer, without any real effect on U.S. Parent.[19]

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[19] Where the seller in a transaction otherwise qualifying as a CAA is a CFC, the same issues as are described in the text are present to an even greater degree. If and to the extent that the transaction results in gain for the selling CFC (which gain will be ultimately be taken into income by the CFC's U.S. shareholders as Subpart F income, as dividends out of an increased pool of E&P, or under Section 1248 upon a sale of the stock of the CFC), that gain eventually will be subject to U.S. taxation. However, the overall net amount of income or gain recognized by such U.S. shareholders over the life of their investment in the CFC might turn out to be unaffected by the fact that the CFC

Furthermore, in both Example 2 and Example 3, one might argue that it is beside the point whether U.S. Parent has incurred a "real" U.S. tax cost as a result of structuring the sale of the foreign operations as an asset sale for U.S. tax purposes rather than as a stock sale. Whether or not U.S. Parent has incurred such a cost, Buyer still has obtained a benefit under the foreign tax credit regime, in the form of an increase in the effective rate of foreign tax that will be imposed on income generated by the acquired foreign assets in post-acquisition periods. Particularly in cases where the seller and the buyer are not related to each other, there arguably is no reason to allow the buyer to enjoy this benefit merely because the seller has incurred a U.S. tax cost on the transaction. In support of this argument, it can be noted that the JCT Report mentions the U.S. tax treatment of the seller in a CAA only very briefly, and the statute does not refer to the seller at all.[20] Instead, the JCT Report and the statute focus on the benefits that the acquirer can potentially achieve under the foreign tax credit regime as a result of structuring a transaction as a CAA, expressing the conclusion that such benefits are inappropriate and should be curtailed.

On balance, we believe it is unclear whether, and in what circumstances, a transaction that results in gain subject to U.S. taxation should be treated as a CAA. It appears to us that considerations of tax policy and Congressional intent could support different approaches to this issue, and we urge that Treasury address the issue in guidance. In particular, one possible distinction that Treasury might draw in guidance is between transactions where the seller and buyer are related, and transactions where that is not the case. When a transaction is between related parties, it generally

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has recognized gain on its sale of assets. In addition, even if repatriation of the CFC's profits from its sale of assets would result in increased U.S. tax for the U.S. shareholders, it might be possible to delay that repatriation of profits indefinitely.

20 The JCT Report observes that in cases where a U.S. person or a CFC sells a foreign corporation, and a Section 338 election is made, the deemed asset sale under Section 338 will generally have U.S. tax consequences for the seller; whereas the deemed asset sale generally will have no U.S. tax consequences for the seller, if the seller is neither a U.S. person nor a CFC. JCT Report at 12.

will be the case that the same U.S. investor(s) will ultimately be subject to U.S. tax on all the income generated by a collection of foreign assets, and also will be entitled to any credits for foreign tax imposed on that income, regardless of whether such assets are transferred between the seller and the buyer or not. This may lessen concerns that a transfer between the seller and the buyer will create a tax advantage without creating any offsetting tax cost in the system.[21] Furthermore, at least in some transactions between related parties, it may be possible to use Section 909 to effectively prevent manipulation of the foreign tax credit regime, making it superfluous to apply Section 901(m) in such cases. For example, if an upper-tier CFC transfers a disregarded entity to a lower-tier CFC in a transaction that is treated as a taxable event for U.S. tax purposes, it might be possible under Section 909 to ensure that the U.S. shareholders of these CFCs are denied a chance to claim Section 902 credits for foreign taxes paid by the lower-tier CFC, until the U.S. shareholders receive dividends out of the E&P of the upper-tier CFC that is created as a result of the transaction.[22]

Thus, while we do not recommend a particular approach to addressing the question of whether to exclude from the definition of a CAA any transactions that result in gain subject to U.S. taxation in the hands of the seller (or U.S. shareholders of the seller), we note that a range of different approaches to this basic issue merit consideration.

C. Transactions "Similar" to Those Listed in Sections 901(m)(2)(A)-(C)

Section 901(m)(2)(D) authorizes the Secretary to identify as CAAs transactions which are "similar" to those listed in Section 901(m)(2)(A) through (C). In this regard, we note that Sections 901(m)(2)(A) through (C) appear to cover the complete range of circumstances in which a transfer of

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[21] Consider, for example, a case where a disregarded entity with a foreign branch is transferred between members of the same consolidated group in a taxable transaction, or where such a disregarded entity is transferred by a U.S. parent corporation to a foreign subsidiary in a taxable transaction.

[22] We discuss further in Part IV.G the interaction between Sections 901(m) and 909.

an equity interest in a legal entity would be treated for U.S. tax purposes as a transfer of the underlying assets held by that entity (or a transfer of a proportionate interest in those underlying assets). We recommend that Treasury and the Service not extend the definition of a CAA under Section 901(m)(2)(D) to transactions in which there is an actual transfer of legal ownership of assets between parties, as opposed to a transfer of shares which is deemed for U.S. tax purposes to be a transfer of the underlying assets. In our view, such restraint is warranted for several reasons.

First, as discussed in detail elsewhere in this report, Section 901(m) is an awkwardly conceived and drafted statute, and taxpayers and the IRS will have to wrestle with a number of difficult conceptual and practical issues when they try to apply it to transactions that are CAAs. In view of these difficulties in applying Section 901(m) to transactions that are CAAs, we believe it is advisable for Treasury not to broaden the definition of a CAA beyond Sections 901(m)(2)(A) through (C), by covering transactions that involve a real movement of assets.

Second, if Treasury and the Service were to decide to include transactions involving actual asset transfers under Section 901(m)(2)(D), this could result in new problems for taxpayers that in fact would be substantially worse than the problems already raised by a narrower definition of a CAA. The transactions described in Sections 901(m)(2)(A) through (C) are, almost by definition, transactions that are the product of deliberate U.S. tax planning. By comparison, a transfer of assets by a foreign entity often will not reflect any such planning:

> Example 4. X Co is classified for U.S. tax purposes as a foreign corporation and has no U.S. 10% corporate shareholder. In 2011, X Co undergoes a restructuring that would be treated as a taxable transaction under U.S. tax principles, even though the transaction is not a taxable one under the tax laws of X Co's country of residence. The restructuring was designed without U.S. tax considerations in mind. Several years later, U.S. Corp acquires the stock of X Co, in a transaction that is not a CAA.

In this example, if the restructuring completed by X Co in 2011 were treated as a CAA, and if U.S. Corp acquired X Co before the last taxable year in which X Co had a "basis difference" under Section 901(m) as a result of that CAA, then it appears that U.S. Corp would be required to reduce its foreign tax credits on account of X Co's basis difference in each remaining year of the depreciable lives of X Co's assets.[23] This would be a highly impractical result. U.S. Corp would be forced to undertake a detailed analysis of X Co's history, applying U.S. tax principles to prior transactions that were not designed with U.S. tax considerations in mind, and seeking to convert to U.S. tax principles records that were prepared for foreign income tax or financial reporting purposes, using a methodology that may differ substantially from that required by the Code and Treasury Regulations. By comparison, if the definition of CAA is limited to cases where a U.S. tax election is made, or where the transaction otherwise is clearly the product of U.S. tax planning such as those expressly described in Sections 901(m)(2)(A) through (C), it will be far easier for a U.S. taxpayer in U.S. Corp's position to determine whether it is inheriting the results of any previous CAAs. Such prior CAAs would not occur accidentally; rather they would, by definition, be the product of deliberate U.S. tax engineering.

Furthermore, the legislative history of Section 901(m) does not suggest that Congress perceived a strong need to cover transactions that involve a real transfer of assets in guidance under Section 901(m)(2)(D). Both the statute (in (A) though (C)) and the JCT Report focus on transactions in which an acquirer obtains a stepped-up U.S. tax basis in the assets of an acquired entity by means of an express election that is available for U.S. tax purposes (under Section 338, Section 754 or Treasury Regulation Section 301.7701-3(c)), or else as a result of using the U.S. entity classification

[23] As discussed further in Parts IV.D, E and F below, we believe that when a U.S. investor engages in an acquisition that is not a CAA with respect to a collection of assets as to which there has previously been a CAA, that U.S. investor should generally "step into the shoes" of the prior owner, inheriting any remaining basis differences that the prior owner would have been required to take into account in over the remaining depreciable lives of the assets.

rules to treat a transaction as an asset transfer for U.S. tax purposes but a share transfer for foreign tax purposes.[24] As noted above, the JCT Report repeatedly alludes to the fact that in such cases, treatment of the transaction as an asset transfer for U.S. tax purposes arises solely as a result of a U.S. tax fiction, which is relevant only for U.S. tax purposes. Although not entirely clear, the implication appears to be that when Congress enacted Section 901(m), it viewed cases where an acquirer can make use of such a U.S. tax fiction as different than, and more troubling than, cases where a transaction is recognized as a transfer of assets for purposes of applicable foreign tax laws and corporate laws. This may be because, where an acquirer can make use of a U.S. tax fiction that is not treated as an asset transfer for foreign tax or legal purposes, the acquirer can obtain a step-up in the U.S. tax basis of the assets of the acquired business without creating any foreign tax costs or consequences or any other types of costs. By comparison, when a transaction involves an actual transfer of assets, such transfer normally would have some foreign tax or other costs or raise foreign legal issues for the parties – the buyer would not be able to obtain a step-up in tax basis for U.S. tax purposes in a simple, wholly costless way.[25]

For all of the above reasons, we recommend that Treasury and the Service refrain from issuing guidance under Section 901(m)(2)(D) that broadens the definition of a CAA to cover actual transfers of assets.

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[24] Some transactions might have this result even if no entity classification election is ever filed for the acquired entity. For example, this would be the case when a U.S. taxpayer acquires the shares of an entity that, pursuant to its default classification under Treasury Regulation Section 301.7701-3, is a hybrid entity (such as a Nova Scotia unlimited liability company). Such a transaction would be a CAA under Section 901(m)(2)(B).

[25] As noted above, the JCT Report states that "It is 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." JCT Report at 14. This statement appears to give direction about one feature that a "similar" transaction identified in regulations would have (i.e., the transaction would result in a basis step-up for U.S. tax purposes but not for foreign tax purposes); the statement does not appear to be an exhortation for Treasury to exercise its authority under Section 901(m)(2)(D) in a broad manner.

If Treasury and the Service choose to reject that recommendation, then we would urge, as a second-best solution, that guidance clearly and strictly limit the categories of asset transfers that will be treated as CAAs. In particular, we would advise that Treasury identify as CAAs under Section 901(m)(2)(D) only transactions in the categories described below. Each of these categories of transactions involves either a U.S. tax election or a common U.S. tax planning technique that results in a step-up in the U.S. tax basis of acquired assets. Accordingly, such transactions would bear a relatively close resemblance to the types of transactions already covered by Sections 901(m)(2)(A) through (C). In addition, for each type of transaction described below, we recommend that such a transaction should be treated as a CAA only if the acquirer in the transaction is (or becomes within a short time after the transaction pursuant to a prearranged plan) a U.S. person; a foreign corporation with respect to which a U.S. corporation meets the Section 902 ownership requirements; a partnership in which a U.S. person or such a foreign corporation owns a material interest; or a disregarded entity owned by any of the foregoing. By limiting regulations issued under Section 901(m)(2)(D) in this manner, it hopefully would be possible to avoid the serious problems described above that would result from defining a broad range of asset transfers to be CAAs.

1. Distributions governed by Section 732(d) or Section 732(b). Under Section 732(d), if a person acquires an interest in a partnership that has not made a Section 754 election, and that person receives a distribution of property with respect to that partnership interest within 2 years after acquiring the interest, then that person can elect to adjust the basis of the property to the same extent (generally) as if a Section 743(b) basis adjustment were in effect for the property. If such a transaction does not result in a step-up in the basis of the distributed property for foreign tax purposes, then the transaction could reasonably be treated as a CAA, given the clear analogy to an acquisition of an interest in a partnership that has made a Section 754 election.[26]

Even if no election is made under Section 732(d), it nevertheless is the case that when a partner receives a distribution of assets in liquidation of its partnership interest, the partner generally will receive an adjusted basis under Section 732(b) in the partnership assets that are distributed. The aggregate basis of the distributed assets will be computed by reference to the partner's basis in its partnership interest. Accordingly, a liquidating distribution to which Section 732(b) applies often can be used as an alternative to an election under Section 754 or Section 732(d), in order for a taxpayer to achieve a step-up in the U.S. tax basis of assets owned by a partnership. Thus, a Section 732(b) distribution could reasonably be identified as a CAA.

2. Section 734 adjustments. Section 734 provides that when a partnership has a Section 754 election in effect, the partnership may adjust the basis of its assets in a manner that generally is intended to eliminate disparities between inside and outside basis that would otherwise result from distributions of partnership property. For example, such disparities might result when the partner receiving a distribution of assets takes a basis under Section 732 in those assets that is lower than the assets' basis to the partnership immediately before the distribution. When the basis of partnership assets is increased under Section 734, the partnership and the non-distributee partners strictly speaking have not acquired the assets in question, at the time the Section 734 adjustment is made. Nevertheless, the end result can be seen as what Section 901(m) is meant to address: as a result of a U.S. tax election, there is an increase in asset basis for U.S. tax purposes that presumably is not matched by a corresponding increase for foreign income tax purposes.

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[26] In such a case, it would be logical to treat the CAA as occurring when the partnership distribution is made with respect to which the Section 732(d) election applies. See Treas. Reg. § 1.732-1(d)(1)(iv).

3. Additional transactions structured principally to increase the effective foreign tax rate. Treasury and the Service might consider issuing guidance that identifies some specific types of asset transfers that are structured using traditional U.S. tax planning techniques, in order to achieve a step-up in asset basis for U.S. tax purposes without treatment as an asset sale for foreign tax purposes. For example, a transfer of assets to a corporation which is structured to fail the "control" requirement of Section 351, by virtue of a pre-arranged sale of stock of the corporation to a non-transferor, has long been recognized as a way to cause a potentially tax-free asset transfer to be characterized as a taxable sale.[27] However, such a transaction often would be treated as a non-taxable transfer of assets for foreign income tax purposes. This type of "busted" Section 351 transaction can thus be seen as essentially similar to a U.S. tax election to treat a transaction as a taxable asset sale for U.S. tax purposes but not for foreign tax purposes. Other specific types of commonly used transactions also can be identified.[28] However, in view of the substantial practical and conceptual difficulties involved with applying Section 901(m), we believe that if any such categories of transactions are identified as CAAs in guidance under Section 901(m)(2)(D), it is best to describe each relevant transaction structure precisely and narrowly in regulations. In this connection, we note that the IRS has the ability to invoke a number of general antiabuse rules and doctrines, in the event it determines that a taxpayer has structured a transaction in a manner that improperly exploits the foreign tax credit regime.

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27 See generally Treas. Reg. § 1.338-3(b)(3)(iv), Example 1.

28 For example, under Granite Trust and related authorities, if a parent corporation owns 80% or more by vote and value of the stock of a subsidiary corporation, and the parent transfers sufficient stock of the subsidiary to one or more other parties to bring the parent's ownership below 80%, with the subsidiary then being liquidated, the liquidation generally is treated as a taxable liquidation under Section 331. See Granite Trust Co. v. U.S., 238 F.2d 670 (1st Cir. 1956); see also Comm'r v. Day & Zimmermann, 151 F.2d 517 (3d Cir. 1945); Comm'r v. Avco Mfg. Corp., 25 T.C. 975 (1956), aff'd, 52 AFTR 1215 (2d Cir. 1957). However, such a liquidation in many cases might not be a taxable transaction for foreign income tax purposes. Thus, if the corporate parent of a foreign corporation takes steps like those permitted under Granite Trust, in order to cause a liquidation of the foreign corporation to be treated as a taxable transaction for U.S. tax purposes, such structuring could be seen as tantamount to an election to treat the liquidation as a taxable asset acquisition for U.S. tax purposes.

4. Merger transactions. A merger (or similar transaction) between foreign corporations may qualify as a tax-free transaction for foreign tax purposes, while being treated as a taxable asset acquisition for U.S. tax purposes. Arguably, because the requirements for a tax-free reorganization under the Code are complex and reflect quirks that often are not replicated in corresponding foreign tax laws, mergers as a class of transactions reflect the same type of basic disconnect between U.S. and foreign tax treatment as characterizes the classes of transactions described in Sections 901(m)(2)(A) through (C). Thus, one approach would be to treat all foreign-law mergers as CAAs under Section 901(m)(2)(D).

However, the treatment of mergers as taxable asset acquisitions for U.S. tax purposes often may be an incidental byproduct of structuring the transactions to meet applicable foreign legal requirements or other requirements unrelated to U.S. tax, rather than a result of U.S. tax engineering. Accordingly, another possible approach (corresponding to that discussed in Part III.C.3 above) would be to provide that only if a merger is structured in a particular manner that is designed to achieve a step-up in assets' U.S. tax basis would the merger be treated as a CAA under Section 901(m)(2)(D).

5. Section 901(m) Not to Apply by Reason of Section 704(c) or Reverse Section 704(c) Allocations. A U.S. partner in a partnership that makes Section 704(c) or "reverse" Section 704(c) allocations arguably bears at least a superficial resemblance to a U.S. taxpayer that benefits from the type of U.S. tax elections or engineered transactions described in Part III.C.1-4 above. However, we believe that such allocations should not cause a partner to fall within the scope of Section 901(m).

It is true that, when a partner contributes appreciated property to a partnership, the non-contributing partner may receive the effect of a step-up under Section 704(c)(1)(A) with respect to that partner's distributive share of depreciation, amortization, and gain or loss attributable to the property. However, when the partnership is subject to foreign income tax, the Regulations under

Section 704 generally require that the resulting "creditable foreign tax expenditure" ("CFTE") must be allocated among the partners in the same manner as the net income of the partnership (as determined for U.S. income tax purposes) to which the CFTE relates.[29] Thus, if a partner contributes a built-in gain asset to a partnership, then when that partner receives a disproportionately large allocation of income or gain related to that asset (or a disproportionately small allocation of depreciation or loss related to that asset) due to the application of Section 704(c), that partner will normally receive a correspondingly large allocation of the CFTE paid by the partnership on the income generated by the asset; and the non-contributing partner will receive a disproportionately small allocation of that CFTE.[30] In other words, the non-contributing partner will be in essentially the same position as if the assets of the partnership had been stepped up for both U.S. and foreign tax purposes. Section 901(m) thus should not apply in such a case. The same should be true in the case of a partner that benefits from "reverse" Section 704(c) allocations.[31]

D. De Minimis Exception to the Definition of a CAA

Section 901(m)(7) expressly contemplates the possibility that regulations will carve out from the scope of a CAA any assets that have a de minimis basis difference. This would be a helpful step in simplifying the application of the statute.

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[29] Treas. Reg. § 1.704-1(b)(4)(viii).

[30] See, e.g., Treas. Reg. § 1.704-1(b)(5), Example 26.

[31] We note that the precise impact of Section 704(c) on the allocation of CFTEs is not entirely clear, in some cases. In addition, Treasury has announced that, in light of Section 909, Treasury and the IRS will be revisiting the CFTE "safe harbor" rules contained in the Section 704 regulations. *See* Notice 2010-92, 2010-52 I.R.B. 916. (Although it is not entirely clear, it appears that Treasury and the IRS are concerned with the special rule for inter-branch transactions contained in Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3), which can lead to the separation, or "splitting," of CFTEs from the associated income.) Nevertheless, we believe the basic principles discussed in the text (regarding the interaction of Sections 704(c) and 901(m)) should apply.

An additional, and more helpful, step would be to exclude a transaction entirely from the definition being a CAA, if the aggregate basis difference for all assets acquired in the transaction fell below a certain level specified in regulations.[32] As a proxy for such a result, we think it would be worth excluding a transaction from the definition of CAA if, shortly before the transaction (say, within the preceding two years), the assets which are the subject of the CAA have been acquired in a transaction in which the basis of the assets for foreign tax purposes was determined based on the price paid for (or fair market value of) such assets. Such an exclusion would identify cases where, even though the transaction under scrutiny did not itself result in a step-up in foreign tax basis, the owner of the assets had incurred the foreign tax cost necessary to accomplish such a step-up shortly beforehand. In such cases, there would be relatively little foreign tax difference between structuring the transaction as an asset sale and structuring it as a share sale, and there also would often not be a big difference between tax basis as determined for foreign tax purposes and the stepped-up U.S. tax basis that results from the transaction. Such transactions thus would not appear to strongly implicate the concerns that led Congress to enact Section 901(m).[33]

An additional step that would be helpful would be to exempt a transaction involving assets with a value below a de minimis threshold from the definition of CAA.[34] Also, a transaction could be exempted from the definition of CAA if it is reasonably expected (taking into account the level of income generated by the acquired assets in the past) that less than a de minimis amount of foreign taxes would be paid each year on income generated by the acquired assets.

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[32] Cf. Section 382(h)(3)(B)(i) (corporation excluded from the "net unrealized built-in gain" ("NUBIG") and "net unrealized built-in loss" ("NUBIL") rules of Section 382, if the corporation's NUBIG or NUBIL does not exceed the lesser of 15% of the fair market value of its assets or $10 million, excluding for purposes of this calculation cash and cash items and marketable securities with a value not substantially different from basis).

[33] If there are particular types of assets that often are volatile, such as public traded equity securities, perhaps such assets could be excluded from the rule just described.

[34] Cf. Treas. Reg. § 1.338-8(d)(3) (acquisition of assets below a stated threshold ($250,000) is excluded from the Section 338 consistency rules).

E. Single CAA versus Multiple CAAs

1. Purchase of an entity with branches in multiple countries. When a purchaser acquires an interest in an entity that owns income-generating assets located in multiple countries, in a transaction that meets the requirements for a CAA, it is possible that the transaction could be viewed as multiple separate CAAs. It appears that such cases often will raise difficult issues that cannot be resolved, except through burdensome calculations and/or the application of arbitrary formulas.

> Example 5. U.S. Corp acquires Forco in a CAA. Forco is a foreign corporation with revenue-generating operations located both in Country 1 (where Forco is tax-resident) and Country 2.

The JCT Report suggests that, in a case like Example 5, it may be appropriate to bifurcate the transaction into separate CAAs of Forco's operations in Country 1 and in Country 2.[35] However, such an approach may involve significant challenges, in many cases.

It seems both logical, and relatively simple, to apply Section 901(m) separately to the Country 2 tax owed by Forco, taking into account only the income and assets of the Country 2 branch. However, the analysis becomes less tidy at the level of Country 1, Forco's country of residence.

If Forco pays income tax in Country 1 on the profits of the Country 2 branch (either on a current basis or on a deferred basis when the profits are repatriated to Forco's home country), then U.S. Corp will face what may well be a time-consuming undertaking, in the event U.S. Corp has to treat the acquisition of Forco as two separate CAAs. In such a case, U.S. Corp would need to compute the amount of income or loss from, and Country 1 tax (if any) owed in respect of, Forco's

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[35] See JCT Report at 15 ("In cases in which there has been a covered asset acquisition that involves….assets in multiple relevant jurisdictions, it is anticipated that the Secretary may issue regulations clarifying the manner in which any relevant foreign asset (such as intangible assets that may relate to more than one jurisdiction) are to be allocated between those jurisdictions."). This statement suggests that the acquisitions in each jurisdiction may be evaluated as a separate CAA.

Country 1 operations, plus the amount of income or loss from, and Country 1 tax (if any) owed in respect of, the branch in Country 2 (which tax would be computed taking into account any Country 1 credit that is available for Country 2 taxes). Such an approach would require a coordinated effort by U.S. Corp's U.S. and foreign tax advisors, in order to compute a set of numbers for purposes of Section 901(m) that will be different from the figures that will be needed for the foreign tax returns that Forco actually files in Country 1; Forco's Country 1 tax returns generally will not require a breakdown of each item included in its overall taxable income (or loss) between its Country 1 operations and its Country 2 branch.

However, there does not appear to be an alternative that would significantly simplify the above calculations, without sacrificing economic accuracy. For example, U.S. Corp could use Forco's total taxable income as computed for Country 1 purposes as well as Forco's total basis differences from all its assets (located in both Country 1 and Country 2), in order to apply Section 901(m) to the Country 1 tax owed by Forco. However, in the event Forco receives a credit in Country 1 for the Country 2 tax it pays, the approach just described will mean that too large a portion of the total Country 1 tax paid by Forco is attributed to its Country 2 branch: the formula just described does not take into account the fact that Forco presumably pays tax at the normal Country 1 statutory rate on its income from its Country 1 operations, while paying Country 1 tax at a reduced rate on its income from the Country 2 branch (reflecting the credit that Forco receives in Country 1 for the Country 2 tax it pays).

Another, even less precise alternative would be for Forco simply to aggregate its Country 1 and Country 2 taxes, and apply Section 901(m) to the total amount of such taxes, by reference to Forco's total income and basis differences from its operations in Country 1 and Country 2. In a simple case where Forco has positive net income from both its Country 1 and its Country 2 operations, Forco's effective tax rate in Country 1 is at least equal to its effective tax rate in Country 2, and Forco receives a full credit in Country 1 for its Country 2 taxes, such an approach might work well. However, in more complicated fact patterns, such a methodology could lead to distortions.

In situations like Example 5, on balance we believe that the first method described above for addressing the tax paid by Forco in its home country (Country 1) is in principle the best method, as it is the most precise, economically accurate way to apply the statutory formula. U.S. Corp would, in other words, treat its acquisition of Forco as two separate CAAs for purposes of applying Section 901(m) to the Country 1 tax paid by Forco – a CAA of Forco's Country 1 operations, and a CAA of Forco's Country 2 branch. However, we recognize this approach often may involve a significant amount of cost and effort for taxpayers and the IRS and, thus, does not represent a truly satisfactory solution.

2. Acquisition of multiple entities in a single transaction. In cases where a single buyer acquires interests in multiple entities in a single transaction, guidance should be provided regarding whether the transaction consists of a single CAA, or several separate CAAs. As discussed below, it appears that an appropriate analysis of each entity that is acquired must take into account both the classification of the entity as either a corporation or a transparent entity (partnership or disregarded entity) under the Code, and also the entity's treatment as transparent or non-transparent under foreign tax law.

a. Entities treated as corporations for both U.S. and foreign tax purposes

In cases where a purchaser acquires, in a single transaction, interests in multiple entities classified as corporations (non-transparent) for both U.S. and foreign tax purposes, it normally will be the case that the purchaser's acquisition of an interest in each entity should be evaluated separately to determine whether that acquisition is a CAA and what the basis difference is for that entity's assets. In such a transaction, a Section 338 election would be made separately for each entity involved, and a separate set of basis adjustments would be made for each entity to reflect the consequences of any such election. In addition, each entity would separately compute its income for both U.S. and foreign tax purposes and have separate E&P and foreign tax credit pools. It thus would be logical to view each entity making such an election as having a separate CAA, with a separate computation under Section 901(m) of basis differences, net income for foreign tax purposes, and foreign income taxes.

In a case where some or all of the entities acquired are members of a single consolidated group for foreign income tax purposes, a single tax base would be computed by aggregating the net income or loss of these entities and imposing foreign tax on the total net amount. However, the foreign tax credit rules contemplate this foreign tax liability typically would be apportioned to each entity based on its allocable portion of the tax basis.[36] It seems consistent with that scheme to apply the CAA rules to each entity separately, using the same methodology as would normally apply to determine each entity's separate net income and apportionment of foreign tax.

b. Hybrid entities

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[36] Treas. Reg. § 1.901-2(f)(3).

It is not entirely clear whether an entity-by-entity approach similar to that described above should apply, when a single purchaser in a single transaction acquires multiple hybrid entities (transparent for U.S. tax purposes but treated as corporations for foreign purposes), or acquires an entity classified as a corporation that owns one or more hybrid entities.

Where a hybrid entity is classified as a partnership for U.S. tax purposes, it would normally be logical to treat the acquisition of an interest in that partnership as a CAA that is separate from the acquisition of interests in other entities in the same transaction. Each hybrid partnership that is acquired will (or will not) have its own Section 754 election in effect, and the acquirer will (or will not) have a separate set of basis adjustments under Section 743(b) with respect to each partnership. In addition, each partnership will compute its own separate items of income and expense under the rules of Subchapter K, and will be treated as a separate entity for purposes of many Subpart F and foreign tax credit rules.

However, the analysis arguably is less clear when multiple hybrids that are treated as disregarded entities for U.S. tax purposes are acquired by a single buyer in a transaction that is subject to Section 901(m) (or are subsidiaries of a single corporation acquired by the buyer in a transaction that is subject to Section 901(m)). In such cases, unlike an acquisition of interests in multiple corporations or partnerships, the general scheme of the Code does not require treatment of each disregarded entity as separate from the regarded person that owns it or from other disregarded entities owned by the same owner. Rather, in periods after the acquisition, the income and foreign tax liability of the owner and of each one of the disregarded entities it holds would be generally aggregated for federal income tax purposes.

Nevertheless, it generally seems reasonable to apply Section 901(m) separately to each hybrid entity that is treated as a disregarded entity for U.S. tax purposes. Assuming that each disregarded entity computes its foreign income tax liability on a separate-company basis (i.e., the entities are not members of a foreign consolidated group), it will be impossible to apply Section 901(m) without first computing on a separate-company basis the foreign income tax liability of each such disregarded entity, as well as the net income of each such disregarded entity. Because all of those numbers would have to be computed in all events in order to apply the statute, and because it should be a straightforward process to compute the basis difference separately for the owner and each disregarded entity, it would not entail a great burden to apply Section 901(m) separately to the owner and each disregarded entity. By comparison, adding together the net taxable income or loss (as computed for foreign tax purposes) of the owner and each disregarded entity would involve extra calculations. In addition, such calculations might lead to incongruous results, if the disregarded entities' respective net incomes for a particular year reflected transactions with one another.

In addition, and more importantly, where the disregarded hybrid entities are tax-resident in different countries, an approach under which their respective taxable incomes are added together could raise (in a limited way) the same type of concerns as apparently led Congress to enact Section 901(m).

> Example 6. Hybrid 1, a disregarded hybrid entity that is tax-resident in high-tax Country 1 and Hybrid 2, a disregarded hybrid entity that is tax-resident in low-tax Country 2, are acquired by the same buyer in a single transaction that is subject to Section 901(m). Hybrid 1 has large positive basis differences in its assets for purposes of Section 901(m), whereas Hybrid 2 does not. Hybrid 1 and Hybrid 2 each has about 100 per year of taxable income for foreign income tax purposes in the years following the transaction.

In Example 6, if the acquisition of Hybrid 1 is treated as a CAA separate from the acquisition of Hybrid 2, then a relatively large amount of the Country 1 income tax paid by Hybrid 1 will be disallowed as a credit under Section 901(m), and a relatively small amount of Country 2 tax paid by Hybrid 2 will be disallowed. By comparison, if the acquisition of the two hybrids is treated as a single CAA, then there will essentially be an averaging of the basis differences of the two hybrids, for purposes of computing the amount of Country 1 tax and Country 2 tax that is disallowed under Section 901(m). Thus, a smaller portion of Hybrid 1's (high) tax paid in Country 1 will be disallowed, and a larger portion of Hybrid 2's (low) tax paid in Country 2 will be disallowed, than if Section 901(m) were applied separately to the two entities. The end result will be that Hybrid 1 pays Country 1 tax on income that is included in Hybrid 1's taxable base for Country 1 purposes, but that is not included in income for U.S. tax purposes due to depreciation and amortization attributable to the relatively large step-up in the U.S. tax basis of Hybrid 1's assets, and that the buyer nevertheless gets a credit under the Code for at least a portion of such tax, as a consequence of the aggregation of the foreign tax paid, basis differences, and foreign taxable income of Hybrid 1 and Hybrid 2.

c. Reverse hybrids

If a buyer acquires multiple entities, one or more of which is a reverse hybrid (corporation for U.S. tax purposes but transparent for foreign tax purposes), then it appears that the acquisition of each reverse hybrid entity should be treated as a separate CAA. The key considerations in such a case are essentially the same as in section a above (dealing with an acquisition of an entity that is treated as a corporation for both U.S. and foreign tax purposes): the buyer will have made a separate Section 338 election for the reverse hybrid, and the reverse hybrid will have its own purchase price allocation and basis adjustments as a result of that election and its own E&P pool in future periods. In light of the rules just described, it would appear logical to treat the acquisition of a reverse hybrid as a separate CAA, notwithstanding the fact that its income for foreign tax purposes may be combined with income of other entities, and that a different entity will incur legal liability for the foreign tax owed on the reverse hybrid's income.[37]

An acquisition of a reverse hybrid would appear to be a "foreign tax credit splitting event" under Section 909. In such a case, it is conceivable that Section 909 could preempt the application of Section 901(m). We discuss the interaction between Section 901(m) and Section 909 below in Part IV.G.

d. Entities treated as transparent for both U.S. and foreign tax purposes

If a purchaser acquires an entity in a CAA that is transparent for both U.S. and foreign tax purposes, then it appears that the proper treatment of the entity under the CAA rules will vary depending on the facts.

For example, if a single buyer acquires several such entities in the same transaction that all carry on activities in the same country, and the income of all of the entities is reported on a single foreign income tax return that the buyer files in that country, then it would appear to be appropriate to treat the acquisition of all these entities as a single CAA. By comparison, if the entities carry on activities in different countries, and the buyer files different foreign tax returns for them, then it would seem that treatment of the transaction as multiple CAAs would be appropriate.

If a purchaser acquires an interest in a non-transparent foreign parent entity in a CAA, and that parent entity in turn owns equity of another foreign entity that is treated as transparent both for U.S. tax purposes and for purposes of the foreign income tax laws to which the parent is subject, then

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[37] It should be noted that where a buyer purchases the equity of a reverse hybrid (or of an entity that is transparent for both U.S. and foreign tax purposes), and the transaction results in a step-up in the basis of the acquired entity's assets for foreign tax purposes, the transaction should not be a CAA, for the reasons discussed in Part III.A.

the transaction could raise issues very similar to those discussed in paragraph 1 above (concerning an acquisition of an entity with branches located in multiple countries).

> Example 7. U.S. Corp purchases the shares of Foreign Parent, a foreign corporation that is subject to tax in Country A. Foreign Parent conducts a business in Country A and also owns Foreign Sub, a disregarded entity that is subject to tax in Country B. Regardless of whether or when Foreign Sub makes distributions to Foreign Parent, Foreign Parent is required under Country A law to include in its taxable income each year all the items of income and expense of Foreign Sub (with the character of those items being the same as if they had been derived by Foreign Parent directly instead of through Foreign Sub). U.S. Corp makes a Section 338 election for Foreign Parent, resulting in a step-up for U.S. tax purposes in the basis of the assets Foreign Parent owns directly, as well as the assets owned by Foreign Sub.

In Example 7, it seems logical to apply Section 901(m) to the Country B tax paid by Foreign Parent by looking solely to the income and basis differences of Foreign Sub. However, U.S. Corp seems to face a choice between alternatives none of which is wholly satisfactory, when dealing with the Country A tax owed by Foreign Parent. On one hand, U.S. Corp could assume the administrative burden associated with trying to split Foreign Parent's Country A tax between its operations in that country and the operations of Foreign Sub in Country B, applying Section 901(m) separately to each piece of the overall whole; on the other hand, U.S. Corp could use a simpler but less precise approach, applying Section 901(m) to the total amount of Country A tax owed by Foreign Parent, without any breakdown between the tax attributable to Country A operations and Country B operations. On balance, we favor the former alternative as the more accurate one, although recognizing that it is not an optimal solution in view of the compliance burdens it creates.

IV. **Other Issues Under Section 901(m)**

A. Identifying "the Income or Gain Attributable to the Relevant Foreign Assets" Under Section 901(m)(1)

1. In general. Section 901(m)(1) refers to the disqualified portion of "any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets." Section 901(m)(4), in turn, provides that for purposes of Section 901(m), "relevant foreign asset" means, "with respect to any covered asset acquisition, any asset (including any goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain or loss attributable to such asset is taken into account in determining the foreign income tax referred to in paragraph (1)." There is an element of circularity in the wording of Sections 901(m)(1) and (4), which can make it difficult to identify the exact items of income and gain that are "attributable" to the "relevant foreign assets" in some cases. It will be important to adopt a realistic, workable approach when construing this wording.

> <u>Example 8</u>. U.S. Corp acquires Forco, a foreign corporation with a business in Country 1, in a CAA. Later, Forco acquires additional assets that will be located in Country 1. Forco will aggregate all of its income and expenses from the business it owned at the time of the CAA and from the later-acquired assets, in computing its taxable income on the Country 1 tax returns it files.

In a case like Example 8, it would be realistic to conclude that the income “attributable to the relevant foreign assets” includes not only the assets acquired in the CAA, but also other assets that are subsequently acquired by the entity that owns the CAA assets, for use as part of a single, integrated business operation together with the CAA assets. In the example, it often would be difficult or impossible to try to compute the hypothetical amount of taxable income tax Forco would have had, if Forco had continued to own only the assets it owned as of the time of the CAA. (In this respect, Example 8 presents a more difficult case than Examples 5 or 7, because in those cases at least different pools of assets are located in different countries and, presumably, are tracked in separate sets of tax and financial records.)

However, it should be noted that taking the practical approach here generally will result in distortions in the application of Section 901(m). U.S. Corp will apply the statutory formula to all of the tax Forco pays in Country 1, even to the extent that such tax is imposed on income that is not economically attributable to the assets that Forco owned at the time of its CAA, but rather is attributable to the other, later-acquired assets that Forco owns. This could lead to a greater (or smaller) disallowance of foreign tax credits under Section 901(m) than would be the case, if it were possible to apply the statute solely with reference to income generated by the assets Forco owned at the time of the CAA. (For example, there would be a distortion if the assets owned by Forco at the time of the CAA do not generate positive net income for foreign tax purposes in a given year, and the other, later-acquired assets generate positive net income that is subject to foreign tax.)

Similar issues are raised when an entity that was purchased in a CAA subsequently acquires assets that comprise a branch in a different country:

> Example 9. U.S. Corp acquires Forco, a foreign corporation that conducts a business in Country 1, in a transaction that is a CAA. Later, in an unrelated transaction that is not a CAA, Forco acquires the assets of another business that is conducted in Country 2.

This example implicates essentially the same concepts that we discussed in Part III.E.1 above (concerning whether an acquisition of an entity with branches in multiple countries is better treated as a single CAA or multiple CAAs). As noted above, there does not seem to be a wholly satisfactory solution in such a case: it is difficult to factor out of the Section 901(m) calculations for Forco the Country 1 tax consequences of its ownership of a branch in Country 2; but if these consequences are not backed out of the calculations required by the statute, then the end result under Section 901(m) generally will reflect distortions.

By comparison, if an entity that was acquired in a CAA subsequently acquires an entity, then considerations corresponding to those described in Part III.E.2.a – d will apply. In general, if the later-acquired entity is a corporation for both U.S. and foreign tax purposes, a hybrid, or a reverse hybrid, then it would be logical to apply Section 901(m) to the entity acquired in the CAA without taking into account any of the income or foreign tax liability of that entity's later-acquired subsidiary. In addition, the wording of Section 901(m)(4) can be read as supporting separate treatment of the later-acquired subsidiary in such cases: when one attempts to identify each "asset…with respect to such CAA," a straightforward reading would be that only assets of the entity that was acquired in the CAA meet this description, rather than assets owned by a different entity.

However, in a limited range of cases that are variations on Example 7 above (dealing with entities that are transparent for both foreign and U.S. tax purposes), it can be asked whether it would be appropriate to apply Section 901(m)(1) not only to income from an entity acquired in a CAA, but also to income of entities that the purchaser owned beforehand and/or acquires afterward in separate transactions.

> Example 10. Forco 1, a CFC, conducts a profitable business in Country 1. In a transaction that is a CAA, Forco 1 acquires the shares of Forco 2, an entity that is transparent both for U.S. tax purposes and for purposes of the tax laws of Country 1.
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> Example 11. U.S. Corp acquires the shares of Forco 3, a CFC, in a CAA. In a later transaction, Forco 3 acquires the shares of Forco 4, an entity that is transparent both for U.S. tax purposes and for purposes of the tax laws of Forco 3's country of residence.

In order to apply Section 901(m) to these examples, it is necessary to make tradeoffs between economic accuracy and administrability that are essentially similar to those discussed in Part III.E.2.d above (in which there is a CAA of a parent entity that owns a transparent subsidiary). In each of these examples, if the income of the parent is combined with the income of the subsidiary for purposes of applying Section 901(m), it is possible to object that income attributable to assets acquired in a CAA is being combined with income from assets that clearly have not been acquired in the same CAA, seemingly in contradiction of the references to income attributable to assets "with respect to the CAA" in Sections 901(m)(1) and 901(m)(4). However, to isolate the income and foreign tax attributable to the assets acquired in the CAA in such cases would involve difficulties that in many cases may not be justifiable. In cases like those just described, we believe the preferred approach would be to isolate the income and tax attributable to the acquired assets; however, we recognize that as a practical matter, it may be burdensome to implement such an approach in many cases.

2. Issues when assets acquired in a CAA are used in multiple branches. As noted above, the Joint Committee on Taxation anticipated that regulations may be issued regarding how to allocate a foreign asset (particularly an intangible asset that may relate to more than one jurisdiction) among jurisdictions, when a single CAA involves both U.S. and foreign assets, or foreign assets in more than one jurisdiction.

This issue should not arise, in the case of an acquisition of a series of separate corporations, hybrid entities, or reverse hybrid entities, each doing business in a single jurisdiction. In such a transaction, each such entity would own particular intangibles and presumably would receive a royalty or other arm's length consideration if other acquired entities, or the acquirer, used the intangible. However, an issue could arise when a CAA involves an entity that has a U.S. and a foreign branch, or multiple foreign branches. Similar issues also could arise when multiple disregarded hybrid entities with operations in different countries are acquired by a single buyer in a CAA (or when a regarded parent and disregarded hybrid subsidiary are acquired in a CAA); under the principles described in Part III.E above, such a transaction generally would be treated as consisting of multiple separate CAAs, but the same basic question of allocating an intangible or other asset among the different countries involved could nevertheless arise in such a case.

Where it is necessary to make an allocation between the United States and a foreign country, it would be appropriate to allocate such an asset in a manner consistent with the allocation of the depreciation or amortization deductions for purposes of determining effectively connected income under Section 882. That allocation, in turn, would generally depend on the amount of income generated by the asset each year in, versus outside, the United States.[38] Although such an allocation could be made each year based on actual results for the year, it would be desirable to add a degree of predictability to the necessary calculations, perhaps by making up-front projections of U.S. and foreign income, which could be revisited from time to time and adjusted if they deviate significantly from actual results. A broad analogy could be drawn to the cost-sharing regulations under Section 482, in which parties bear the cost of an intangible in proportion to the benefits (e.g., revenues, units sold, operating profits) it is reasonably anticipated to generate for each of them.[39]

To the extent that a single transaction includes an acquisition of operations in multiple foreign countries, a similar approach could be used to allocate an asset and related depreciation and amortization deductions among those operations.

B. Calculation of Basis Differences: Use of Foreign, versus U.S., Tax Basis

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[38] See generally Rev. Rul. 75-483, 1975-2 C.B. 286 (allocating depreciation deductions for a taxable year based on the amount of revenue generated by the depreciated asset in and outside the United States in that year).

[39] See Treas. Reg. § 1.482-7T. In practice, the allocations required under Section 901(m) should typically be far simpler to make than those called for by the Section 482 regulations.

Where a taxpayer acquires assets in a CAA, and the seller is required to determine the basis of the assets for the seller's U.S. tax reporting, Section 901(m) mandates the use of U.S. tax basis immediately before the CAA in order to compute the taxpayer's "basis differences" from the CAA.[40] However, the JCT Report states that it is anticipated that Treasury will issue regulations identifying circumstances in which foreign, rather than U.S., tax basis immediately before the CAA may be used for this purpose.[41] On balance, we believe that the appropriate result would be to allow a taxpayer to elect to use either of these two alternatives (pre-transaction U.S. tax basis, or foreign tax basis) when computing basis differences for a CAA. As discussed below, we believe this result is supported by the statute's legislative history as well as compelling practical considerations.

Plausible arguments could be made for using either foreign tax basis, or pre-transaction U.S. tax basis, in order to compute basis differences for purposes of Section 901(m). Depending on the facts of a particular transaction, and one's view of the intent behind Section 901(m), each alternative may look like the better one in some cases but not in others.

> Example 12. Forco owns a single asset, which has a U.S. tax basis of 0 and a foreign tax basis of 150. The asset is depreciable for both U.S. and foreign tax purposes. U.S. Corp acquires the shares of Forco in a CAA for 150.

On one hand, it can be argued that in a case like Example 12, the concerns that led Congress to enact Section 901(m) are absent. The JCT Report focuses on the fact that a CAA can create a "permanent difference" between the amount of income of an acquired foreign entity that is subjected to foreign income tax in post-acquisition periods, and the amount of the entity's income that will be

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40 See Section 901(m)(c)(3)(C).

41 JCT Report at 14. We note that, in the case of a transaction that meets the requirement for a CAA that we have described in Part III.A above (i.e., no step-up in foreign basis as a result of the transaction), it should not matter whether foreign tax basis immediately before, or immediately after, the CAA is used for purposes of calculating basis differences.

subjected to U.S. taxation.[42] In Example 12, assuming that Forco's asset is depreciable or amortizable for foreign tax purposes, there will not be such a permanent difference. Over time, the amount of income that Forco recognizes for foreign tax purposes will be the same as the amount of Forco's income or E&P as computed under the Code; thus, it will not be possible for U.S. Corp to claim a credit for foreign taxes imposed on income of Forco that is permanently excluded from the U.S. taxable base.

On the other hand, in Example 12, U.S. Corp has managed to decrease the amount of Forco's income that will be subject to U.S. taxation in periods after the CAA. U.S. Corp has done this without affecting (reducing) the amount of foreign tax that Forco will pay in post-acquisition periods. Thus, U.S. Corp has been able to use the CAA to boost the effective rate of foreign tax imposed on Forco's income (as computed under the Code); and U.S. Corp has done so without any party having to incur a real cost in order for U.S. Corp to derive this U.S. tax advantage. Arguably, these are circumstances that Congress intended to reach when it enacted Section 901(m); and, under this logic, it is appropriate for U.S. Corp to measure its basis difference for purposes of Section 901(m) by reference to the excess of the stepped-up U.S. tax basis of Forco's asset, over the pre-transaction U.S. tax basis of the asset. Admittedly, it is somewhat difficult to reconcile this logic with the emphasis in the JCT Report on CAAs creating "permanent differences" between the foreign taxable base and the U.S. taxable base. In addition, the denominator of the Section 901(m)(3)(A) fraction for computing the "disqualified portion" is taxable income as computed for foreign tax purposes; and in light of that, it would seem logical for the numerator (i.e., the basis difference) to be the amount by which such taxable income would be reduced, if the tax basis and depreciation expense used for foreign tax

42 JCT Report at 12-13.

purposes was as big as the basis and depreciation expense used for U.S. tax purposes.[43] However, notwithstanding these points, it is undeniable that the formula that Congress chose to include in Section 901(m) for computing basis differences looks to the pre-transaction basis of the assets as computed under U.S. tax principles.

A different fact pattern further illustrates the point that arguments can be made for measuring basis differences by reference to either foreign tax basis, or pre-transaction U.S. tax basis.

> Example 13. Forco owns a single asset with a U.S. tax basis of 150 and a foreign tax basis of 0. Forco's asset is depreciable for both U.S. and foreign tax purposes. U.S. Corp acquires the shares of Forco in a CAA for 150.

In such a case, it seems intuitively unfair for U.S. Corp to be stuck with a basis difference of 150, which would be the result if U.S. Corp computed Forco's basis difference by reference to foreign tax basis. If U.S. Corp had chosen to structure its acquisition of Forco as a transaction that was not a CAA, U.S. Corp would have been left with a 150 excess of U.S. tax basis over foreign tax basis; U.S. Corp thus has not improved its position as a result of having structured the deal as a CAA. (In fact,

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[43] Consider the following example. U.S. Corp acquires Forco in a CAA for 150, at a time when Forco owns a single asset with a foreign tax basis of 100 and a historic U.S. tax basis of 0. Forco's U.S. tax basis in its asset is stepped up to 150 as a result of the CAA. The next year, Forco uses its asset in a business and generates 200 of income from that business. At the end of the year, Forco sells its asset for 300. For foreign tax purposes, Forco's taxable income is 400 (200 of operating income plus a gain of 200 from its sale of its asset). Thus, under Section 901(m)(3)(A)(ii), Forco's "disqualified portion" is computed using a denominator of 400.

Section 901(m)(3)(A)(i) states that Forco's "basis difference" is the numerator of the "disqualified portion" fraction. If Forco uses 50 in the numerator (150 U.S. tax basis minus 100 foreign tax basis), then the resulting fraction is 50/400. In essence, this represents the amount by which Forco's taxable income for foreign tax purposes would have been decreased, if Forco's foreign tax basis in its asset was 150 rather than 100. By comparison, if Forco computes its "basis difference" as 150 (stepped-up U.S. tax basis of 150 minus historic U.S. tax basis of 0), then Forco's "disqualified portion" is 150/400. This result appears incongruous. One might be able to argue that the fraction here should be 150/500: the numerator (150) would be computed by comparing the asset's stepped-up U.S. tax basis to the asset's historic U.S. tax basis; and the denominator (500) would be the amount of Forco's taxable income computed under U.S. tax principles, using Forco's historic U.S. tax basis in its asset. That formula would represent the reduction in Forco's taxable income (as computed using U.S. tax principles) that is obtained as a result of the step-up in the U.S. tax basis of Forco's asset from 0 to 150. However, 150/400 – the actual result under the language of the statute – is a worse answer, and lacks any apparent justification. (Neither the statute nor the JCT Report contain a reference to the formula leading to the 150/500 outcome, although as discussed in the text, the JCT Report does suggest 50/400 may be the right answer.)

since U.S. Corp has restarted the period for depreciation of Forco's asset for U.S. tax purposes, U.S. Corp may be worse off as a result of structuring the transaction as a CAA than it would have been if it had simply chosen not to adjust the historic U.S. tax basis of Forco's asset.) It is true that the JCT Report's remarks about "permanent differences" suggest that Congress focused on a comparison between foreign tax basis and post-acquisition U.S. tax basis; but that comparison arguably is misleading, in Example 13.

On the other hand, however, it might be argued that Congress simply did not view it as relevant how large of a U.S. tax benefit an acquirer could have enjoyed, if the acquirer had chosen to inherit the historic U.S. tax basis of the acquired entity's assets. Arguably, Congress' only concern was that by structuring a transaction as a CAA, the acquirer had taken an action that put the acquirer in a position to claim "excess" foreign tax credits with respect to income that never would be subject to U.S. tax in the acquirer's hands. Consistent with the basic principle that a transaction structured as an asset acquisition erases the U.S. tax history associated with the acquired assets, Congress may have decided that application of Section 901(m) should not turn on that history – including the fact that the previous owner of the assets may have enjoyed a U.S. tax advantage from having a high U.S. tax basis in the assets. However, while such an argument can perhaps be reconciled with the discussion of Section 901(m) in the JCT Report, it clearly is at odds with the actual language of the statute.

On balance, it appears to us that Congress was prepared to accept the use of either pre-transaction U.S. tax basis, or foreign tax basis, in order to compute basis differences under

Section 901(m). The JCT Report suggests that Congress viewed both choices as reasonable means of carrying out the intent behind Section 901(m):

> For purposes of determining the aggregate basis difference allocable to a taxable year, the term "basis difference" means, with respect to any relevant foreign asset, the excess of (1) the adjusted basis of such asset immediately after the covered asset acquisition, over (2) the adjusted basis of such asset immediately before the covered asset acquisition. Thus, it is the tax basis for U.S. tax purposes that is relevant, and not the basis as determined under the law of the relevant foreign jurisdiction. Because CFCs are generally limited to straight-line cost recovery, it is anticipated that the basis difference applying U.S. tax principles generally is less than if the taxpayer were required to use the basis as determined under foreign law immediately before the covered asset acquisition. However, it is anticipated that the Secretary will issue regulations identifying 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 asset under the law of the relevant jurisdiction or another reasonable method.[44]

The quoted passage indicates that Congress believed the use of pre-transaction U.S. tax basis, rather than foreign tax basis, would generally be a favorable choice for a taxpayer, as in Example 13, and Congress had no objection to that pro-taxpayer result. Rather, Congress was prepared to allow an acquirer to benefit if the acquired assets had a high U.S. tax basis in the hands of their previous owner. In addition, the passage indicates that the use of pre-transaction U.S. tax basis in the statute does not reflect any fundamental principle or policy choice by Congress which would be offended if, in a case like Example 12, foreign tax basis were used instead of pre-transaction U.S. tax basis. Indeed, the Joint Committee notes that it expects regulations will be issued under which taxpayers may be permitted to use foreign tax basis, as a "reasonable method" of implementing the statute.

On balance, we believe it would be consistent with Congress' intent in enacting Section 901(m) for Treasury to allow taxpayers an election between using pre-transaction U.S. tax basis, and

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[44] JCT Report at 14.

foreign tax basis, when they compute their basis differences under Section 901(m)(3). As explained above, each of these alternatives will work reasonably well in some, but not all, cases as a means of implementing the statute. It does not appear that Congress had a strong preference for one over the other: the JCT Report suggests that, in Congress' view, the use of foreign tax basis would generally fit best with the policy goals of the statute; but the statute itself uses historic U.S. tax basis. Ultimately, the passage quoted above suggests that Congress was prepared to let taxpayers have the benefit of the better of the two alternatives. Thus, we think it would be appropriate to give a taxpayer the right to elect to use foreign tax basis, rather than historic U.S. tax basis, when measuring basis differences from a CAA under Section 901(m)(3).

Furthermore, we note that compelling practical considerations support allowing taxpayers to elect to use foreign tax basis, instead of pre-transaction U.S. tax basis, when computing basis differences. In particular, if there is a CAA and the seller in that transaction never was required to determine basis for U.S. tax reporting purposes, it may be a highly burdensome undertaking for the buyer to determine the U.S. tax basis of the assets immediately before the CAA.[45] The buyer generally will be required to review at length foreign tax and accounting records that have been prepared without U.S. tax in mind, using principles that do not correspond closely to the rules in the Code for determining basis. Indeed, this is one of the key reasons why a buyer would often structure an acquisition as a CAA in such circumstances: the buyer wishes to eliminate the U.S. tax history of the acquired entity rather than having to attempt to reconstruct or create that history. In order to provide taxpayers with relief from the administrative burden just described (and the IRS with relief from the need to review elaborate U.S. tax basis calculations in audits of Section 901(m) issues),

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45 Cf. Mary F. Voce, Basis of Foreign Property that Becomes Subject to U.S. Taxation, 49 The Tax Lawyer 341 (1996).

Treasury should allow the purchaser to use foreign tax basis in such cases. Records presumably will have been kept by the acquired entity to indicate what the foreign tax basis is.

In addition to being able to determine basis differences by reference to foreign tax basis in cases where there is a CAA and the seller has not been subject to U.S. tax reporting, it also appears that practical considerations would support letting a buyer look to foreign tax basis in a range of other cases. For example, it is possible that as a commercial matter, a U.S. seller will be reluctant to agree to share information about the historic U.S. tax basis of the assets being acquired in a CAA, or that the buyer will not want to perform the due diligence needed to confirm that the information provided by the seller is accurate. It also is possible that a U.S. seller may not have computed the exact U.S. tax basis of the assets being sold at the time a CAA has occurred, if the U.S. seller has not previously had a reason to do so. In such cases, it may be more feasible, and less burdensome, for the buyer to be allowed to use the foreign tax basis of the assets that are acquired for purposes of measuring basis differences under Section 901(m)(3), instead of being required to determine the U.S. tax basis of the assets immediately before the CAA.

Thus, it would be both logical and practical for Treasury to allow taxpayers the choice to use foreign tax basis in order to measure basis differences under Section 901(m)(3), instead of being forced to determine the U.S. tax basis of the relevant assets as of the time immediately before the CAA.[46]

C. Consequences if Net Basis Difference for a Year is a Negative Amount

[46] In Part IV.F below, we discuss a further practical benefit to allowing a taxpayer to use foreign tax basis. As discussed in that section, use of foreign tax basis allows for easier application of the statute in a case where the same assets are the subject of a series of successive CAAs.

If the sum of a taxpayer's basis differences from a CAA in a given year is a negative amount, then that negative amount cannot be taken into account in the year in which it arises; under Section 901(m)(3)(A)(i), a taxpayer's aggregate basis differences for a given year cannot be less than zero. However, if a taxpayer's negative aggregate basis differences for a particular year are completely ignored for purposes of Section 901(m), then the taxpayer's foreign tax credits will be reduced excessively: the sum of the taxpayer's basis differences for other years will exceed the aggregate net step-up in basis that the taxpayer has actually obtained in the CAA.

One way to deal with this issue would be to allow a taxpayer to carry over a net negative basis difference in order to offset net positive basis differences in other years. Depending on the mix of assets involved in a CAA, it might make more sense to carry the negative basis difference forward or back. For example, if the assets acquired in a CAA consist of long-lived depreciable real property with a basis that has been stepped-up by 100 and short-lived equipment that with a basis that has been stepped-down by 100, then a carryforward would make sense: the purchaser in such a CAA would have relatively large net negative basis differences in the early years following the transaction (attributable to the equipment's decline in value), offset gradually in later years by positive basis differences (attributable to the appreciated real property). By comparison, if the facts in this example are reversed, so that the equipment has a step-up and the real property has a step-down, then a carryback would be necessary. In this connection, it should be noted that the step-down in the basis of the real property would be stretched over many years, so that some of the early years in which the taxpayer has a positive basis difference might have closed before the taxpayer finishes realizing the entire negative basis difference in the real estate.

In order to avoid such results, it may be preferable to provide up-front for an automatic reduction in the net positive basis differences that are projected to occur in years following the CAA, by the net negative differences that are projected to occur. One way to accomplish this would be to provide that a taxpayer will only realize positive basis differences each year, up until the time when the sum of the positive annual basis differences realized by the taxpayer from the CAA, is equal to the net step-up in basis that the taxpayer has obtained in the CAA.[47] In some cases, such an approach might lead to highly favorable results, which Treasury might view as unjustified: for example, this might be true where the negative basis difference associated with real property that is depreciable only over a very long period (or not at all) is used to offset a positive basis difference for inventory or for financial assets that are marked to market. However, it appears it should be possible to address any such concern if, for example, the assets acquired in a CAA are divided into different baskets – perhaps one for inventory and assets marked to market, and another for all other assets – and netting of positive and negative basis differences occurs only within each basket.

D. Meaning of "Disposition" in Section 901(m)(3)(B)(ii)

Section 901(m)(3)(B) provides that when there is a "disposition" of an asset that has been acquired in a CAA, all of the remaining basis difference for that asset is taken into account under Section 901(m) in the year the disposition occurs. The statute does not define "disposition." However, in view of the basic policy goal that appears to underlie the statute, as well as considerations of administrability, the following principles appear appropriate.

1. Taxable asset transfers

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[47] Such an approach would be conceptually similar to, for example, the "net unrealized built in gain" and "net unrealized built in loss" rules in Section 382(h). Under those rules, a loss corporation gives special treatment to items of "built in gain" or "built in loss" that are recognized after an ownership change only to the extent of the aggregate net amount of built in gain or built in loss, respectively, that is inherent in the loss corporation's assets at the time of the ownership change. Similarly, Treasury Regulation Section 1.1502-36(d)(3) generally provides that a loss recognized by a member of a consolidated group on a sale of shares of a subsidiary member is disallowed only to the extent of the excess of the aggregate basis of the shares over their aggregate value (or, if less, the excess of the aggregate basis of the subsidiary's assets (less liabilities) over the value of the subsidiary's shares).

A taxpayer should be treated as having a disposition in two cases. First, there should be a disposition when an asset acquired by the taxpayer in a CAA is later transferred in a transaction that results in the recognition of gain for foreign income tax purposes. This is true regardless of whether the transaction is a taxable transaction for U.S. tax purposes.[48] There are two reasons for reaching this conclusion:

> (1) The arbitrage that Section 901(m) is intended to address has been realized, once such a transaction occurs: there are no future differences between the foreign tax base and the U.S. tax base that remain to be taken into account. Thus, there is no reason to continue to haircut the amount of foreign tax credits that a U.S. person is entitled to claim after the transaction.

> (2) If the transfer of the applicable asset is a taxable transaction for foreign income tax purposes, that may mean large foreign taxes are due in the year of the transfer, due to realization of a gain for foreign income tax purposes. In light of this, it seems appropriate to trigger the remaining basis difference in that year, rather than spreading it out over future years when may be less foreign income tax.

It should be noted that, if a transfer of an asset results in recognition of gain for foreign tax purposes in an amount that is less than the full remaining basis difference associated with that asset (or results in recognition of a loss for foreign tax purposes), then the taxpayer should be required to take into account in the year of the transfer only that portion of the basis difference which equals the gain (if any) that is recognized for foreign tax purposes. The taxpayer has not gotten the full benefit

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[48] See JCT Report at 15 ("[I]t is intended that this provision 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.").

of the difference between the foreign tax base and the U.S. tax base that is represented by the asset's basis difference, in a case where a transfer of an asset results in foreign taxable gain that is less than the full amount of the basis difference (or a foreign taxable loss).

In addition to the above, there is also a second case where the taxpayer should be treated as having a "disposition" of an asset: a transfer by the taxpayer of an asset in a transaction that results in recognition of a loss for U.S. tax purposes. In such a case, the taxpayer has essentially accelerated its unamortized basis difference to the year of the transfer that results in the loss. The taxpayer can use such loss in the year when the transaction occurs to offset the taxpayer's income from the assets that the taxpayer acquired in the relevant CAA; thus, the taxpayer can reduce the net amount of income generated by those assets for U.S. tax purposes, without a corresponding decrease in the net amount of income recognized for foreign tax purposes or foreign tax paid on that income. In such a case, it is logical to treat the taxpayer as having a "disposition" of the asset in question, in order to disallow a portion of the taxpayer's foreign tax credit for the year that reflects the taxpayer's realization of the remaining basis difference in that year. For purposes of this analysis, the foreign tax treatment of the transaction in which the taxpayer transfers the asset should be irrelevant.

It should be noted that if the taxpayer recognizes a loss for U.S. tax purposes that is less than the full amount of the taxpayer's basis difference for the asset in question, the taxpayer should have a "disposition" only to the extent of the loss recognized.[49]

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[49] It also should be noted that the two rules described in the text could both apply to the same transaction; that is, the same transaction could result in a taxpayer recognizing a gain for foreign tax purposes (the first rule described in the text) and recognizing a loss for U.S. tax purposes (the second rule described in the text). In such a case, it appears that the two rules would generally work together to produce correct results. For example, suppose that after a CAA, Forco has a U.S. tax basis of 150 in an asset and a foreign tax basis of 80 in that asset, and Forco computes its basis difference by reference to foreign tax basis. Forco thus has a basis difference of 70. Suppose Forco sells the asset for 100, in a transaction that is a taxable event both for foreign tax purposes and for U.S. tax purposes. In such a case, the first rule described above would result in Forco having a basis difference of 20 for the year the transaction occurs: 20 equals the amount of gain recognized for foreign tax purposes (100 sale price minus 80 foreign tax basis). Under

2. Transactions other than taxable asset sales. If the taxpayer engages in a transaction that does not meet the requirements described in Part IV.D.1, then the transaction generally should not be a "disposition" under Section 901(m)(3)(B)(ii). We describe below some common types of transactions that normally should not be dispositions.

a. Stock sales

> Example 14. U.S. Corp acquires the shares of Forco in a CAA. U.S. Corp later sells the shares of Forco in a transaction that is not a CAA and that does not result in a step-up in asset basis for foreign income tax purposes.

In the example, if the acquirer of Forco is a U.S. person, that U.S. person should "step into the shoes" of U.S. Corp.[50] This is because the U.S. acquirer is getting ownership of Forco at a time when Forco still has a portion of its basis step-up from the prior CAA. If Section 901(m) were found not to apply to the U.S. acquirer, that result would seem at odds with the policy underlying the statute, and an invitation to avoidance transactions. For symmetry, it would be appropriate to treat U.S. Corp as not having a "disposition." Instead, in periods following the transaction, U.S. Corp simply would not take into account any basis differences for Forco that are attributable to such periods, since these

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the second rule described above, Forco would have a basis difference of 50 for the same year (150 U.S. tax basis minus 100 sale price). Forco's total basis difference for the year would be 70 (20 under the first rule plus 50 under the second rule).

The same principles would apply in this example, if a decision is made to compute Forco's basis difference by reference to pre-transaction U.S. tax basis. For instance, suppose all the facts are the same as in the above example, and Forco has a U.S. tax basis of 70 in the asset in question before the CAA. In that case, Forco would have a basis difference of 80 for the asset (150 purchase price minus 70 pre-transaction U.S. tax basis). Under the two rules described in the text, Forco would have a "disposition" to the extent of 70 out of this 80 basis difference; the calculations leading to that result would be the same as above. This would leave a remaining basis difference of 10 (80 minus 70); and that 10 would generally be inherited by the asset's new owner, under the principles described in Parts IV.E and IV.F below. By comparison, if Forco had a pre-transaction U.S. tax basis of 90 for the asset, then Forco would have a basis difference of 60; and Forco would take into account that entire 60 basis difference when the transaction occurs.

[50] As discussed in Part IV.E below, while this type of "step in the shoes" approach seems theoretically sound, it also may require a significant amount of record sharing and cooperation between U.S. Corp and the subsequent buyer of Forco, so as to ensure the consistent application of Section 901(m) by them.

would be left for the acquirer to take into account (along with Forco's profits subject to foreign income tax for those periods).

It also would be appropriate to treat U.S. Corp as not having a "disposition" in such a case, even if the buyer of Forco is not a U.S. person (or a CFC). In the example, the transaction is not treated as a sale of assets for U.S. tax purposes or for foreign tax purposes. Thus, when the transaction is completed, U.S. Corp does not recognize any gain or loss that reflects the remaining basis difference in Forco's assets. (This is true regardless of whether the taxpayer computes its basis difference using foreign tax basis, or using U.S. tax basis immediately prior to the CAA.) However, since U.S. Corp no longer owns Forco after the transaction, U.S. Corp should not be required to take into account in periods following the transaction any basis differences attributable to those periods.

The proper treatment of the person acquiring Forco from U.S. Corp is discussed further in Parts IV.E and IV.F below.

b. Tax-free asset transfers

In Example 14, if the facts are varied so that following the CAA, Forco transfers its assets to some other corporation in a transaction that qualifies under Section 381 for U.S. tax purposes and that is also tax-free for foreign income tax purposes, then it generally would be appropriate for the transferee corporation (and its U.S. shareholders, if it is a CFC) to take into account over time the unrecovered portion of the basis differences that were previously calculated for Forco's assets. It would seem inappropriate for U.S. Corp to be tagged with a "disposition." The same would generally be true in a Section 721/731/351/355 transaction that is tax-free for foreign income tax purposes.[51]

In other transactions in which Forco transfers an asset in a manner that is tax-free for both U.S. and foreign tax purposes, and in which Forco ends up owning property with an exchanged basis (e.g., a transaction qualifying under Section 1031), it would be appropriate to treat the asset received by Forco as a substitute for the asset that has been transferred, for purposes of Section 901(m).

c. Termination of use of an asset in foreign operations

The same logic as is in Parts IV.D.1 and IV.D.2.a and 2.b above also should apply to a transaction following which an asset that was acquired in a CAA is no longer used in foreign operations. One example would be a permanent repatriation by Forco of an asset to the United States. If the repatriation is accomplished by a transaction that does not result in recognition of gain or loss in respect of the asset for U.S. or foreign tax purposes, it appears that such a transaction should not be treated as a disposition. However, such a transaction should be sufficient to entitle Forco's U.S. owner to cease taking into account basis differences from the relevant asset that are attributable to periods following the transaction.[52]

Another example would be the abandonment or destruction of an asset that had been acquired in a CAA. In such a case, assuming the owner of the asset recognizes a loss for U.S. tax purposes, it would appear the transaction should be treated as a disposition, under the principles articulated in Part IV.D.1.

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[51] Guidance could provide that if a transfer is only partially tax-free, so that a taxpayer recognizes a portion of the gain or loss inherent in the transferred assets, then the transaction would be a partial disposition.

[52] By comparison, in keeping with the principles described in Part IV.D.1, the repatriation of the asset would be treated as a disposition if the repatriation transaction results in recognition of gain for foreign tax purposes or recognition of loss for U.S. tax purposes.

E. Treatment of Acquirer of Assets in a Transaction Not Constituting a CAA, When the Assets Were the Subject of a Previous CAA

As described above with regard to Example 14, in a number of cases where a person acquires assets in a transaction that is not a CAA, and those assets still have a basis difference under Section 901(m) from an earlier CAA (i.e., there has not been a "disposition" of the assets that has wiped out the remaining basis difference), it would be logical to treat the acquirer as inheriting that basis difference.[53] In such cases, as a practical matter, there often will be a need for record-sharing and cooperation between the acquirer and the previous owner or owners. However, there does not appear to be a need to mandate that the seller and the buyer use consistent calculations, as opposed to allowing each to follow its own best judgment. (For example, a buyer and seller of assets are not required by the Code to agree on an allocation of the purchase price; and a U.S. shareholder selling its interest in a CFC to a new U.S. shareholder is not required to agree on the computation of the CFC's E&P with the new U.S. shareholder.)

F. Treatment of Acquirer of Assets in a CAA, When the Assets Were the Subject of a Previous CAA

If a series of successive CAAs occur with respect to the same foreign assets, then it appears that under the literal language of the statute, the last acquirer is potentially left with the results of all the prior CAAs, in addition to having to deal with the consequences under Section 901(m) of the acquirer's own CAA. Even though an acquisition of an entity that is treated for U.S. tax purposes as an asset purchase ordinarily serves to purge the entity's U.S. tax history from pre-acquisition periods, the statute contains no indication that an acquirer in a CAA is allowed to "turn off" unamortized basis differences from prior CAAs. This makes sense, because otherwise the last acquirer in a series of

[53] Where the acquisition of the assets in question is a transaction that results in a "disposition" of the assets for the seller, the seller would take into account the remaining basis differences relating to the assets, and there would be nothing left for the buyer to inherit. The buyer thus would be free of Section 901(m).

CAAs could potentially benefit from basis step-ups that prior acquirers had obtained, without having to suffer a disallowance of foreign tax credits.

In order to create an orderly framework to address a situation involving a series of successive CAAs, the following principles seem appropriate. First, provided that the acquirer is permitted to and does choose to measure its basis differences based on the difference between U.S. tax basis immediately after the acquirer's CAA and foreign tax basis at the time of the transaction, the acquirer logically should not need to examine the history of prior CAAs in order to apply the statute properly. In such a case, the full amount of income that the acquirer could have that is subject to foreign but not U.S. tax (i.e., the income with which Section 901(m) is concerned) should be identified simply by looking to the excess of the U.S. tax basis in the acquirer's hands, over the foreign tax basis. (This is an a further practical advantage to allowing taxpayers to elect to use foreign tax basis when measuring basis differences under Section 901(m), in addition to the advantages noted above in Part IV.B.)

Second, if an acquirer in a CAA does not (or is not permitted to) use foreign tax basis to measure the acquirer's basis differences, then the acquirer should determine whether there have been any previous CAAs. If there has been a previous CAA, then the acquirer should inherit any basis differences from that CAA that have not yet been realized.

> <u>Example 15</u>. A buys Forco, a foreign entity that owns only a single asset, in a CAA for 100 in 2011. Immediately before the transaction, Forco's U.S. tax basis in its asset was 60. A opts to compute the basis difference for Forco's asset by reference to the asset's pre-transaction U.S. tax basis. In 2012, A sells Forco to B in a CAA for 150, at a time when there has not been any disposition of Forco's asset. Immediately prior to the 2012 CAA, the U.S. tax basis of Forco's asset is 100 (i.e., unchanged from the time of the previous CAA). B decides to compute its basis difference from the 2012 CAA by reference to pre-transaction U.S. tax basis.

In Example 15, B should have a 90 basis difference for Forco's asset. Out of the total basis difference of 90, 50 is from B's own CAA (150 U.S. tax basis immediately after that CAA minus 100 U.S. tax basis immediately before the transaction). The remaining 40 is from A's CAA of Forco in 2011 (100 U.S. tax basis immediately after that CAA minus 60 U.S. tax basis immediately before that CAA).

In principle, this type of approach should be followed even if the taxpayer in a previous CAA has opted to compute basis differences by reference to foreign basis, rather than pre-transaction U.S. tax basis.

> Example 16. C buys Forco, a foreign entity that owns only a single asset, in a CAA for 100 in 2011. At the time of the transaction, Forco's foreign tax basis in its asset was 70. C opts to compute the basis difference for Forco's asset by reference to the asset's foreign tax basis. In 2012, C sells Forco to D in a CAA for 150, at a time when there has not been any disposition of Forco's asset. D decides to compute its basis difference from the 2012 CAA by reference to U.S. tax basis; and, immediately before the 2012 CAA, Forco continued to have a 100 U.S. tax basis in its asset.

In Example 16, D has a 50 basis difference from the 2012 CAA. In addition, it would seem that D should inherit the basis difference of 30 from the previous CAA, even though that basis difference is computed by reference to foreign tax basis; if this were not the case, then D could enjoy a U.S. tax advantage that would be denied to the previous owner of Forco, a result counter to the purposes of the statute. (An alternative would be for D to determine the U.S. tax basis of Forco's asset before the 2011 CAA; in principle this would seem to be an acceptable approach, and one that is consistent with D's preference to use U.S. tax basis to measure its basis difference.)

Under the principles described above, similar considerations regarding cooperation and sharing of records would arise to those discussed in Part IV.E.

G. Interaction with Section 909

In general, under Section 909, a "foreign tax credit splitting event" ("Splitting Event") occurs when a person that is related to the payor of a foreign income tax takes into account, under U.S. federal income tax principles, the income related to such tax.[54] If there is a Splitting Event, then the person paying the applicable foreign income tax cannot take such tax into account for purposes of Sections 901, 902 or 960 until that person has taken into account the income on which the tax is imposed. In Notice 2010-92, 2010-52 I.R.B., the IRS requested comments as to whether a CAA should be treated as a Splitting Event.

Although it will not always be the case that a CAA is also a Splitting Event, there are a number of transactions that could qualify as both. For example, a taxpayer's acquisition of a reverse hybrid entity with a Section 338 election could qualify as both a CAA and a Splitting Event. In addition, depending on whether Treasury chooses to exclude from the definition of CAA transactions in which a U.S. person or CFC recognizes gain (as discussed in Part III.B above) and transactions that involve actual transfers of assets (as discussed in Part III.C above), it is possible that a transfer of a disregarded entity or of assets to a CFC in a transaction designed to result in a step-up in U.S. tax basis (e.g., a busted Section 351 transaction) could qualify as a CAA and also as a Splitting Event.

In cases where a transaction is both a CAA and a Splitting Event, it becomes necessary to establish whether, as between Section 901(m) and 909, one provision should preempt application of the other; and, if both provisions can apply to the same transaction, an order of precedence between the two provisions needs to be established. As described in Part III.B, in some cases involving transactions between a related buyer and seller, it might make sense for Section 909 to preempt

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[54] See Section 909(a), (b); see also New York State Bar Association Tax Section, Report on Issues Under Section 909 of the Code (Report No. 1223, November 8, 2010).

Section 901(m). In such cases, the same U.S. person or persons will directly or indirectly own both parties to the acquisition transaction and, ultimately, will be subject to U.S. tax on all of the income associated with the acquired foreign assets as well as being entitled to all the foreign tax credits relating to that income. In such cases, there may be less of a reason to permanently disallow any foreign tax credits (under Section 901(m)), than simply to ensure that the credits are not taken into account by the relevant U.S. person or persons until those persons are subject to U.S. tax on the related foreign income (under Section 909).

However, subject to the possibility of Section 909 preempting Section 901(m) in such cases, it appears that as a general matter, neither provision should apply to the exclusion of the other, because Section 909 and Section 901(m) are designed to address different concerns (timing mismatches versus artificially shrinking the U.S. taxable base relative to the foreign taxable base). The most logical approach to applying these provisions in tandem appears to be first to apply Section 901(m) each year following a CAA, in order to determine how much foreign tax will be permanently disallowed under that provision. The remainder of the foreign tax in question can then be deferred under Section 909 and taken into account in whichever future year the relevant foreign income is taken into account. (For example, in the case of an acquisition of a reverse hybrid in a CAA, the acquirer would have legal liability for the foreign tax owed on the reverse hybrid's income. A portion of the foreign tax credit for such tax would be disallowed, as determined under the formulas in Section 901(m); and the remainder of the foreign tax credit for that tax would be deferred until the acquirer took into account the income on which the foreign tax was imposed.) The alternative to the methodology just described would be to apply Section 909 first, and defer the entire amount of foreign tax payable in a given year, without first making a determination whether any part of the tax will be disallowed under Section 901(m); then, when the foreign tax is taken into account under Section 909 in a later year, Section 901(m) could be applied in that year, using the basis differences (if any) that are allocated to that later year. There do not appear to be compelling reasons to use this alternative approach: it seems somewhat arbitrary to use basis differences that arise in a different year than the year in which the applicable foreign income tax liability first was imposed and the related taxable income was first realized for foreign tax purposes. We thus recommend the former approach.