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Proposed §901(m) Regulations and Simple Partnerships

By Kimberly S. Blanchard, Esq.
Weil, Gotshal & Manges LLP
New York, New York

A long time coming, the proposed §901(m) regulations[1] are on balance a finely crafted and well thought out implementation of a poorly conceived piece of legislation. Because the proposed regulations are carefully designed and thought through, they illustrate, better than any article might, the arbitrariness of the statutory provision. This short piece will flesh out one of many possible examples where the statutory provision leads inevitably to results that no thinking human being would ever wish upon taxpayers or the tax enforcement agency.

Section 901(m) disallows the ''disqualified portion'' of a foreign tax credit that a U.S. person might otherwise claim where there has been a ''covered asset acquisition'' (''CAA''). The statute itself lists three types of CAAs, being §338 purchases, acquisitions of a partnership interest where a §754 election is in effect, and a transaction that is treated as an asset acquisition for U.S. tax purposes but as a stock acquisition for foreign tax purposes. In addition, the statute authorizes the Internal Revenue Service to treat other similar transactions as CAAs. To calculate the disqualified portion, one must divide the aggregate basis differences allocated to a given tax year with respect to relevant foreign assets (''RFAs'') by the foreign income tax base. Although the statute provides that the aggregate basis differences are determined by comparing the U.S. tax basis of the relevant foreign asset before and after the CAA, it authorizes the IRS to provide that the basis difference is instead the difference between the U.S. tax basis and the foreign tax basis of the relevant asset.

Both the statute and the regulations apply based on objective facts, without regard to any purposive planning by taxpayers. Therefore, the statute and regulations, subject to a *de minimis* exception contained in the latter, apply to the following everyday fact pattern. Suppose you have an international family business operated in partnership form. The partners are unrelated U.S. and foreign individuals joining together to make widgets or to provide services. The partnership operates in several different countries, including the United States. To keep the example simple, we will assume that the partnership operates in foreign countries directly and not through local-country corporations.[2]

The partnership has had in effect, long before §901(m) was enacted in 2010, a §754 election. The election insures that when a family member dies or transfers her partnership interest to another family member, a U.S. transferee will not suffer an uneconomic double-counting of gain with an offsetting, and possibly unusable, loss. Similarly, if appreciated property is distributed to a partner in liquidation of her interest, any gain recognized by that partner will give rise to a common basis adjustment to the partnership, such that the same gain will not be recognized twice (with an offsetting and often unusable loss). Assume that the proposed regulations are finalized in their current form, and that a U.S. partner dies, transfers her

[1] REG-129128-14 (Dec. 7, 2016). Temporary regulations were also issued, but are generally limited to implementing the disposition rules of Notice 2014-44, 2014-32 I.R.B. 270, and Notice 2014-45, 2014-34 I.R.B. 388. All section references are to the U.S. Internal Revenue Code, as amended (the ''Code'') or the Treasury regulations thereunder, unless otherwise indicated.

[2] If the partnership is domestic, that is, formed under U.S. law, then any local-country subsidiaries would be treated as controlled foreign corporations as to which the indirect credit system of §902 and §960 comes into play. But if the partnership is formed under foreign law, its foreign subsidiaries may not be CFCs.

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partnership interests or is redeemed out of the partnership after the effective date of those regulations and at a time when the value of the partnership's assets, including goodwill, has appreciated.

This simple example will also assume that no *de minimis* exception set forth in the proposed regulations will apply. The proposed regulations do contain *de minimis* exceptions, and the example set out here is a good illustration of why they do. In general, the regulations would not apply if either: (1) the cumulative basis difference with respect to the CAA is less than the greater of $10 million or 10% of the total basis of all RFAs after the CAA, or (2) the basis differences for all RFAs in a particular class (e.g. goodwill) is less than the greater of $2 million or 10% of the total basis of all RFAs in that class.[3] However, if the transferor and transferee are related persons, which by definition they would be in this simple example, the thresholds just listed are halved, using $5 million, 5% and $1 million.[4] This rule is difficult to understand, given the objective nature of §901(m) — and is especially harsh as applied to individuals. A transfer of a partnership interest is treated the same way whether made to a related person or not. The final regulations should provide an exception for individuals, retaining an existing proposed anti-abuse rule.

In the event of a sale of a partnership interest, §743(b) will require that the adjusted basis of the partnership's assets be stepped up to reflect the fair market value basis taken by the transferee. This is a CAA under the statute and the regulations. Therefore, the U.S. transferee must keep track of the RFAs of the partnership, determine the basis difference with respect to each RFA,[5] determine the rules for taking into account that basis difference over time, and determine the disqualified portion of any foreign taxes that are creditable. The transferee must do this separately for each country in which the partnership operates.

The first obstacle that our U.S. transferee will face will be trying to figure out who the ''foreign payor'' is within the meaning of Prop. Reg. §1.901(m)-1(a)(23), that is, the person who is ''subject to'' foreign tax. The same issue will arise in determining who is an ''RFA owner (foreign)'' within the meaning of Prop. Reg. §1.901(m)-1(a)(32). If the foreign country in question treats the partnership as a taxpayer, then the partnership is the foreign payor and RFA owner (foreign). If it does not, then only the partner is the foreign payor and RFA owner (foreign). One might think this determination is as simple as asking whether the foreign country views the partnership as an opaque corporation or as a transparent partnership. But it is not that simple. Many foreign countries view partnerships as transparent, but nevertheless have rules requiring the partnership to pay tax on behalf of the partners, and view the partnership as ''subject to'' tax. The proposed regulations refer to the technical taxpayer rules at Reg. §1.901-2(f)(4), which are equally confusing on this score. Hopefully, the final regulations will make clear that in such cases, only the partner is the foreign payor and RFA owner (foreign).

The proposed regulations define another term, ''RFA owner (U.S.),'' to mean the person who is treated as owning the relevant asset for U.S. tax purposes. The main reason it is important to know who the RFA owner (U.S.) is, is that this person can make a foreign basis election under the proposed regulations. In this case, the RFA owner (U.S.) is clearly the partnership. However, consistent with §703(b)(3), which provides that any election to credit foreign taxes is made at the partner level, the proposed regulation provide that each partner of the partnership may make the election.

The foreign basis election is important. Where the election can be made, the U.S. taxpayer can compute the basis difference in an RFA by comparing the stepped-up U.S. tax basis to foreign basis, as opposed to comparing the U.S. basis before and after the CAA. Thus, if there is also a basis step-up under foreign law, there will be nothing for §901(m) to apply to. In order to make the foreign basis election, one needs to know not only the relevant U.S. tax basis information under §755, but also the relevant foreign tax basis information. In a large partnership, particularly one with many foreign partners who are indifferent to these rules, obtaining that information may often be difficult. Moreover, the §755 regulations are notoriously complex. (This is the reason that the §743 regulations require that a transferee provide notice of a transfer encompassed by that section.)

For this reason, the proposed regulations provide a rather odd and elaborate exception to the timely filing requirement for a partner making the election. A partner may make the election on an amended return only if, prior to the due date for her original tax return, she ''delegated the authority to the partnership to choose whether to provide the partner with information to apply section 901(m) using foreign basis, either pursuant to a written partnership agreement . . or written notice provided by the partner to the partnership.''[6] The preamble to the regulations explains that this excess of caution was deemed necessary ''to prevent

[3] Prop. Reg. §1.901(m)-7(b).

[4] Prop. Reg. §1.901(m)-7(c)(1).

[5] The temporary regulations helpfully provide a rule that the basis difference is the §743(b) basis adjustment allocated to a particular RFA. Reg. §1.901(m)-4T(d)(1).

[6] Prop. Reg. §1.901(m)-4(c)(5)(iii).

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partners from using hindsight in determining whether to make the foreign basis election.'' One wonders how often partners lacking *foresight* will stumble over this requirement. This requirement should be deleted.

As noted above, the regulations require the entire exercise to be performed separately with respect to each foreign country in which an RFA is located. In the case of a multinational partnership, it is possible that different countries will have different views of whether the partnership is tax-transparent or not. And each foreign country may have different rules regarding how basis is adjusted, or not, upon the transfer of a partnership interest, including at death. Taken together with the §755 regulations, the §901(m) exercise could keep a team of tax accountants busy for an entire year. One can only dream of what the already-impenetrable instructions to Form 1116 will say about any of this.

As a general matter, any unallocated basis difference is taken into account upon a disposition of an RFA. However, a partnership interest is not an RFA. It follows that if the transferee in an original §743(b) CAA re-transfers her partnership interest to someone else (including an existing partner), no disposition has occurred. Fortunately, the temporary regulations step into the breach here and provide that if the entire partnership interest is sold, there will be no unallocated basis difference in the hands of the seller. This is because the buyer will need to apply §901(m) all over again. But if less than all the partnership interest is sold, the parties will have to ''equitably apportion'' the unallocated basis difference between them.[7]

I think this simple example illustrates that the statutory scheme of §901(m), especially as applied to partnerships, is deeply flawed. The provision is not based on any fundamental principle of tax law. It is a mere rifle-shot revenue raiser. There is no *a priori* reason why the failure of foreign law to reflect a step-up in tax basis as calculated for U.S. tax purposes should cause a dilution in the U.S. foreign tax credit, any more than any other naturally occurring base difference should do so. Despite the fact that the international provisions of the Code employ a credit rather than an exemption system to ameliorate the incidence of both U.S. and foreign tax applying to the same income, the Code does not give effect to foreign tax systems, for the very good reason that it would be impossible to do so. Any limitation on the FTC is achieved already by the limitation set forth in §904.

As applied to partnership basis adjustments, the statutory scheme is particularly inapt. One might admit that a §338 election for a foreign target is in most cases ''frictionless'' in that it normally would give rise to no tax consequences to the foreign target. But this is not true in the case of a §754 election. The election serves to prevent double taxation, and is available only when a recognition event has occurred for U.S. tax purposes. Due to the manner in which Subchapter K is designed to apply, there are many examples of transactions that give rise to a U.S. tax basis step-up that may or may not match the results obtained under foreign law. As just one example that does not seem to be covered by the proposed regulations, §736(b) can result in a deduction equivalent for zero-basis goodwill in the hands of the remaining partners of a partnership that has redeemed in full the interest of a retired partner. For all we know, there is no basis adjustment under most foreign laws for many of these partnership transactions, perhaps because foreign law does not result in double counting the way U.S. law does. There is no *a priori* reason to think that the lack of a foreign basis step-up allows a U.S. partner to ''hype'' foreign tax credits. It is much more likely that these rules will result in aggravated and unrelieved double taxation.

The proposed regulations significantly broaden the classes of transactions subject to §901(m). In my view, the regulations should have done the opposite. They should narrow the application of the §754 CAA such that it is limited to transactions that can give rise to hyping of foreign tax credits in cases where no partner suffers a tax cost. Because there is no normative principle at stake, the statute should be narrowed to the greatest extent possible. The regulations should limit CAAs to those set out in the statute, and should adopt generous *de minimis* and other exceptions so that the focus is on only large corporate transactions. That will be enough to keep the accountants busy!

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[7] Reg. §1.901(m)-6T(b)(4)(iii).

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