Impact of Code Sec. 901(m) on Foreign Acquisitions

Beginning in 2011, Code Sec. 901(m) applies to certain foreign acquisitions. That provision denies a credit for a portion of foreign income taxes paid by a foreign target that is subject to the new rule.

The scope of the new rule is limited. Only “covered asset acquisitions” are subject to Code Sec. 901(m). Also, the rule does not affect other U.S. tax consequences to the buyer (and it has no impact for foreign tax purposes). Finally, the new rule does not alter the tax consequences to a seller (U.S. or foreign).

A covered asset acquisition is an acquisition treated for U.S. purposes as an acquisition of assets but for foreign purposes is treated as an acquisition of stock (or disregarded). Perhaps the most common example is a Code Sec. 338(g) election for a foreign target. Under Code Sec. 338, the buyer is treated as organizing a new corporation that acquires the assets of the target, resulting in a stepped up basis of the target’s assets. The election also eliminates the target’s historic tax attributes and closes its tax year. For foreign purposes, the transaction is treated as a purchase of stock and thus the inside asset basis is not adjusted. On the other hand, Code Sec. 901(m) would not apply where the foreign country treats the transaction as an acquisition of assets or no Code Sec. 338 election is made for a target corporation.

The portion of foreign income taxes denied as a credit are taxes paid by the foreign target on the amount of its income that is unreduced by the additional amortization and depreciation deductions resulting from the basis step-up for U.S. tax purposes. Specifically, this is calculated as the ratio of the aggregate basis differences allocable to such tax year with respect to all relevant foreign assets divided by the income on which the foreign income tax is determined. Noncreditable foreign income taxes are deductible.

While Code Sec. 901(m) reduces the amount of creditable foreign taxes, a Code Sec. 338 election can continue to provide foreign tax credit benefits. For example, assume stock in a foreign target (“FT”) is purchased for $100 and a Code Sec. 338(g) election is made. The inside asset basis is $20, which is stepped up to $100. Assume that the additional $80 of basis is amortized over a 10-year period (i.e., $8 annually). Also, assume that FT has $20 of income (before the additional amortization) subject to a 30-percent foreign tax.
rate, resulting in $6 of foreign taxes. FT’s U.S. income and earnings would be $6 ($20 – $8 – $6).

Prior to Code Sec. 901(m), the effective tax rate of the foreign target’s pool of earnings would be 50 percent [$6 ÷ ($6 + $6)]. If the $6 of earnings were distributed to the United States, the excess foreign tax credits would be $1.80 [$6 – ($4.20 ÷ ($6 + $6) x 35%)]. After Code Sec. 901(m), $2.4 of the foreign target’s income taxes would be disallowed as a credit ($8 x 30%). The effective tax rate of FT’s pool of earnings would be 37.5 percent [$3.6 ÷ ($6 + $3.6)]. If the $6 of earnings were distributed to the United States, the excess foreign tax credits would be $0.24 [$3.60 – [$3.36 = ($3.6 + $6) x 35%]]. On the other hand, if no Code Sec. 338(g) election were made, the U.S. parent would be entitled to $6 of foreign tax credits, but the effective tax rate on the earnings would be 30 percent, resulting in incremental tax on a dividend.

There are significant additional benefits of making a Code Sec. 338(g) election. The elimination of the foreign target’s tax attribute history, including earnings and basis in assets, avoids complex and uncertain determinations (although Code Sec. 901(m) requires a calculation of historic basis for foreign tax credit purposes). Post-acquisition restructuring is accommodated by the elimination of the foreign target’s earnings and profits and the step up in the basis of its assets, avoiding subpart F gains and dividends on integration transactions. A Code Sec. 338(g) election also can provide subpart F benefits. Closing the foreign target’s tax year avoids pre-acquisition subpart F income being taxable to the buyer. Moreover, the additional U.S. deductions for amortization and depreciation would reduce subpart F income to the extent allocated or apportioned to such income.

Making a Code Sec. 338 election for a foreign target generally does not result in any U.S. tax consequences to the buyer or to a foreign seller, but can affect a U.S. seller’s tax consequences. The earnings resulting from the target’s deemed sale of its assets is taken into account for purposes of determining the amount of the gain recharacterized as an ordinary dividend under Code Sec. 1248, which increase could reduce the amount of capital loss utilization. In addition, the IRS takes the position that the additional earnings can dilute the seller’s deemed paid foreign tax credits accompanying the deemed dividend.\(^1\) A U.S. seller generally will seek indemnification for its additional tax costs.\(^2\)

While generally it is beneficial for a buyer to make a Code Sec. 338(g) election, under certain circumstances it may be more advantageous not to make such election. Without an election, the foreign target retains all of its historic tax attributes. One important attribute is previously taxed income (PTI), which includes amounts taxable to a U.S. seller under Code Sec. 1248.\(^3\) In addition, if a foreign target has U.S. property (e.g., U.S. intangibles), there is grandfather relief when the seller is foreign, and the basis is not stepped up to fair market value which would be the amount treated as a deemed dividend under subpart F. In addition, without a Code Sec. 338(g) election a high-taxed earnings pool or deficits of a foreign target would be preserved, which provide repatriation and subpart F benefits.

Code Sec. 901(m) will reduce the foreign tax credit benefits of a Code Sec. 338(g) election for a foreign target (or other transaction treated as an asset acquisition for U.S. purposes but not foreign purposes), but does not eliminate the benefits. Also, there are other important benefits of making the election. Nevertheless, there may be certain circumstances where not making such an election is the better option.

**Endnotes**

1. New Code Sec. 901(m) can also apply when a buyer acquires interests in a disregarded entity that is treated as an acquisition of stock or is disregarded for foreign tax purposes.


3. If the target is owned by a foreign subsidiary of a U.S. seller, such seller may desire to elect to classify the target as disregarded to avoid U.S. taxation of the gain under subpart F, in which case the buyer should achieve the benefits of a Code Sec. 338 election without an indemnification cost to the U.S. seller. See Lowell D. Yoder, Pre-Sale Branch Election for CFC Target: Dover v. Comr. Says No Subpart F Income, 33 Tax Mgmt. Int’l J. 474 (Aug. 13, 2004).

4. Code Sec. 959. PTI can be distributed to the U.S. shareholder without being again subject to U.S. taxation, and such amounts are treated as being distributed before untaxed earnings.