

Section 338 Elections in the Age of Covered Asset Acquisitions

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Effective January 1, section 901(m) limits the “hyped” foreign tax credit benefit that formerly accompanied making a section 338(g) election on the purchase of a foreign target corporation. Yoder and Clary argue that despite this new limitation, a section 338(g) election generally will still prove advantageous for the buyer of a foreign target corporation by continuing to provide the purchaser with an enhanced FTC result and additional post-acquisition U.S. tax benefits.

A. Introduction

Historically, it has been beneficial for a U.S. corporation to make an election under section 338(g) on the purchase of a foreign target corporation. That was generally true whether the U.S. corporation purchased the stock of the foreign target directly or through a controlled foreign corporation, and irrespective of whether the seller was foreign or domestic.¹ The election provides a fair market value basis in the assets of the foreign target, which can be depreciated or amortized for U.S. tax purposes, thereby reducing the post-acquisition earnings and profits of the foreign target. That results in a U.S. foreign tax credit benefit from the imposition of the foreign tax on post-acquisition income of the target, unreduced by the additional depreciation and amortization deductions attributable to a stepped-up basis of the target’s assets that reduced the target’s E&P for U.S. tax purposes. That FTC benefit has sometimes been referred to as a “hyped” FTC benefit.

Also, the tax history of the foreign target, including pre-acquisition E&P, is purged as a result of the election, resulting in a fresh start for the entity in the

¹As discussed below, there are potential U.S. tax consequences to a U.S. or CFC seller of a foreign target corporation when a section 338(g) election is made by the buyer.

U.S. corporation’s organization structure. As discussed below, that clean slate for the target provides maximum flexibility for post-acquisition integration transactions involving the target within the acquiring corporation’s structure. These benefits generally came with little or no U.S. tax cost to the buyer,² so the U.S. corporation made the section 338(g) election in most instances.

Enacted as part of the Education Jobs and Medicaid Assistance Act of 2010 (the 2010 act),³ new section 901(m), effective January 1, 2011, is intended to limit the hyped FTC benefit that previously accompanied an acquisition of a foreign target with a section 338(g) election. While the enactment of section 901(m) may diminish the prior FTC benefit of making a section 338(g) election for a foreign target, as discussed below, in many circumstances it will likely remain beneficial for a buyer to make the election because (1) while diminished, there generally remains a U.S. FTC benefit associated with making a section 338(g) election; and (2) there are additional benefits, apart from the U.S. FTC benefit, resulting from the election.

B. Base Example

The following example will be used to illustrate the considerations in making a section 338(g) election on the purchase of stock in a foreign target corporation following the enactment of section 901(m).

Base example: A U.S. corporation (USP) owns 100 percent of the stock of CFC. CFC purchases 100 percent of the stock of a foreign target corporation (FT) from a foreign seller for \$100, and an election under section 338(g) is made for FT. For U.S. federal tax purposes, FT’s assets have an FMV of \$100 and an

²In some instances, a section 338(g) election could result in immediate U.S. tax to the buyer. For example, assume that the purchaser acquired the stock of a CFC in a “creeping acquisition” (*i.e.*, the required 80 percent of the foreign target stock was purchased in several transactions). If the deemed asset sale resulting from a section 338(g) election generated subpart F income and the buyer was a 10 percent or greater shareholder before the acquisition date, the buyer would have to include its portion of the subpart F income resulting from the deemed sale of the CFC’s assets. See reg. section 1.338-9(f)(2), Example 4.

³P.L. 111-226.

aggregate basis of \$50.⁴ For purposes of U.S. depreciation and amortization rules, FT's assets have an average recovery period of 10 years. FT is subject to a 30 percent foreign income tax rate.

Before the enactment of section 901(m), a decision to make a section 338(g) election on the purchase of the FT stock from a foreign seller often would have been made with little consideration. The election provided an FMV basis in the assets of FT (\$100) and the associated hyped FTC benefit described above. FT's tax history (for example, E&P) was eliminated, and its tax year ended on the acquisition date. Further, CFC had no reason to determine the U.S. tax basis of FT's assets before the acquisition. Under the facts of the base example, those benefits for the purchaser came without any U.S. tax costs to or impact on the seller because the seller of the FT stock is foreign and not subject to U.S. tax.

C. Overview of Section 338

1. Making the election. Under section 338, a purchasing corporation may elect to treat a qualified stock purchase (QSP) of a target corporation as an asset purchase for U.S. tax purposes. The purchasing corporation and the target corporation may either be domestic or foreign (for example, a U.S. corporation can make a section 338(g) election on the purchase of a U.S. or foreign target, or a CFC can make a section 338(g) election on the purchase of a U.S. or foreign target).⁵ The election is made unilaterally by the acquiring corporation.⁶

As described above, there are two threshold requirements permitting an acquiring corporation to make a section 338(g) election: The purchaser must be characterized as a corporation for U.S. tax purposes,⁷ and the acquisition of the target's stock must constitute a QSP.

⁴As discussed below, the determination of FT's historic asset basis for U.S. tax purposes may be extremely complicated, if not impossible. However, one of the complexities of section 901(m) is that the determination of the FTC denied under the section requires the purchaser to determine the pre-acquisition asset basis of the foreign target for U.S. tax purposes.

⁵Section 338(d)(1) provides that the term "purchasing corporation" means *any* corporation that makes a QSP of the stock of another corporation. Similarly, section 338(d)(2) provides that the term "target corporation" means *any* corporation the stock of which is acquired by another corporation in a QSP.

⁶Section 338(g)(2). The election must be made by the 15th day of the ninth month following the month in which the acquisition occurs. Section 338(g)(1). Once made, the election is irrevocable. Section 338(g)(3).

⁷Under section 338(a), only a purchasing corporation may make the election described in section 338(g). Generally, this

(Footnote continued in next column.)

A QSP means any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2))⁸ of one corporation is acquired by another corporation by purchase during the 12-month acquisition period.⁹ The term "purchase" means any acquisition of the target's stock by the purchasing corporation other than carryover basis transactions,¹⁰ nonrecognition transactions (that is, exchanges to which section 351, 354, 355, or 356 applies),¹¹ or related-party transactions.¹²

If made, the election treats the target corporation (Old Target) as having sold all its assets at the close of the acquisition date at fair market in a single transaction, and it treats a new corporation (New Target) as purchasing all the assets that were sold by Old Target as of the beginning of the day after the acquisition date.¹³ When the dust settles, the acquiring corporation owns New Target, a new corporation for U.S. tax purposes, with an FMV basis in all its assets, no tax history (for example, E&P), and a new tax year beginning the day after the acquisition date. As discussed above, the FMV basis in the target's assets and the fresh start for the target has generally made the election desirable from a buyer's perspective.

A purchasing corporation may decide to make tiered section 338(g) elections on the purchase of a foreign target. For example, assume in the base example that FT owns 100 percent of the stock of a foreign subsidiary (FS) and a U.S. subsidiary (USS). If CFC makes a section 338(g) election for FT, elections can be made for FS and USS.¹⁴

2. Impact on the seller. As described in the context of the base example, when the seller of a foreign

requirement does not create significant concern if the purchasing corporation itself, and its ownership of the target corporation, are not transitory. See reg. section 1.338-3(b)(1).

⁸Thus, to make a section 338(g) election, the purchasing corporation must acquire stock of the target corporation constituting 80 percent of the vote and 80 percent of the value.

⁹The 12-month acquisition period is the 12-month period beginning with the date of the first acquisition by purchase by the purchasing company of stock of the target corporation included in a QSP. Section 338(h)(1).

¹⁰Section 338(h)(3)(A)(i).

¹¹Section 338(h)(3)(A)(ii).

¹²Section 338(h)(3)(A)(iii). Generally, a transaction will not constitute a QSP if the stock of the seller is treated as constructively owned by the purchasing corporation under section 318. However, section 338(h)(3)(C) does treat some related-party transactions as a QSP.

¹³Section 338(a).

¹⁴Generally, to the extent there is built-in gain in the assets of a U.S. company, a section 338(g) election is not made, because U.S. corporate tax would be imposed on the built-in gain of those assets. However, an election might be considered to the extent the U.S. company had net operating losses that could shelter the tax on the asset gain.

target is foreign and not subject to U.S. taxation, a section 338(g) election made by the purchaser should have no effect on the seller. However, when the seller of a foreign target is a domestic corporation or CFC, a section 338(g) election made by the purchaser could have a U.S. tax impact on the seller, and accordingly, the seller may try to prohibit the purchaser from making an election or seek an indemnity for any resulting U.S. tax costs in the purchase and sale agreement.

Specifically, gain from the deemed sale of the target corporation's assets under section 338 may increase the target's E&P for its tax year, thereby diluting the seller's FTCs.

For example, assume that in the base example FT was owned by a U.S. seller rather than a foreign seller. Assume further that before that acquisition, the U.S. seller had a \$50 basis in the stock of FT, and FT had \$20 of accumulated untaxed E&P and \$7 of foreign income taxes. If no section 338 election were made on CFC's purchase of FT for \$100, under section 1248 the U.S. seller would have \$30 of capital gain and \$20 of foreign-source general basket income with \$7 of deemed-paid FTCs.¹⁵

As discussed above, if a section 338(g) election is made by CFC on the purchase of FT, FT would be treated as selling all its assets at the close of the acquisition date. That deemed sale of assets would generate \$50 of additional E&P (the aggregate basis of FT's assets is \$50). That would result in all the U.S. seller's \$50 of gain being treated as ordinary income, which could limit the use of capital losses.¹⁶ Also, the deemed sale gain would increase FT's general basket earnings pool to \$70. According to the IRS, the additional \$50 of general basket earnings are taken into account for purposes of calculating the deemed-paid taxes that accompany the section 1248 amount, and therefore those taxes would be reduced from \$7 to \$5 (50/70 multiplied by \$7).¹⁷ Even though all the U.S. seller's gain (\$50) would be ordinary income under section 1248, under section 338(h)(16) the U.S. seller would continue to have only \$20 of general basket foreign-source income.¹⁸

¹⁵For purposes of this illustration, the proration of current-year earnings and taxes is ignored.

¹⁶See reg. section 1.338-4(h)(8), Example 4.

¹⁷See Lowell D. Yoder, "CCA 200103031: Does Section 338(h)(16) Apply to Deemed-Paid Credits?" 30 *Tax Mgmt. Int'l J.* 443 (2001).

¹⁸Generally, an increased section 1248 amount would result in an FTC benefit, *i.e.*, additional general basket foreign-source income. Section 338(h)(16), however, provides that the seller's additional section 1248 amount resulting from the CFC target's gain on the deemed sale of its assets cannot be treated as general basket foreign-source income, but must be sourced based on the source of the capital gain on the sale of the stock (*i.e.*, U.S.-source

(Footnote continued in next column.)

Further, if FT has passive assets, gain resulting from their deemed sale under the section 338 election would result in subpart F income that is taxable to the U.S. seller. The basis in the FT stock would correspondingly be increased for purposes of calculating the U.S. seller's gain. If FT recognizes an amount of passive subpart F income that has the effect of reducing the U.S. seller's section 1248 amount, the amount of the U.S. seller's general basket foreign-source income may correspondingly be reduced, as well as the amount of deemed-paid FTCs.¹⁹

3. Situations in which a section 338 election may not be made. While a section 338(g) election generally has been advantageous to the purchaser of a foreign target, there are situations in which the election would not be beneficial, even before the enactment of section 901(m). As discussed above, as a result of a section 338(g) election, the historic attributes of the foreign target, including E&P, are eliminated. However, to the extent the foreign target is a CFC that has favorable attributes — such as previously taxed income, high-taxed E&P, or deficits in E&P — a section 338(g) election may not be beneficial, since the continued existence of those attributes may provide the purchaser with significant post-acquisition benefits. Previously taxed income would include the section 1248 amount recognized by the U.S. seller, and that amount can be distributed to the buyer (as the successor in interest) without again being subject to U.S. taxation.

Further, to the extent there is a built-in loss in the assets of the foreign target, a section 338(g) election may not be beneficial. Assume in the base example that the aggregate basis of FT's assets was \$150 for U.S. tax purposes and that FT has no E&P for U.S. tax purposes. If CFC were to make a section 338(g) election on the acquisition of FT, the basis of FT's assets would be reduced to FMV (\$100). Given the absence of any historic E&P in FT, making a section 338(g) election in this case would likely be detrimental as a result of the asset basis step-down. However, developing historic basis information to achieve sufficient comfort that there is a loss in the FT assets for U.S. tax purposes may be difficult. One of the most important benefits to purchasers provided by a section 338(g) election has been the fresh start given to the target corporation for U.S. tax

or passive basket foreign-source income). Therefore, that additional section 1248 amount does not result in an FTC benefit. See LTR 8938036 (the historic E&P is taken into account first, a beneficial rule).

¹⁹See Yoder, "Selling CFC Stock with a Section 338 Election: Section 1248 and Foreign Tax Credit Consequences," 33 *Tax Mgmt. Int'l J.* 375 (2004).

purposes, making the determination of the FT's historic asset tax basis irrelevant. However, as described below, the enactment of section 901(m) has given importance to the target's historic asset basis for U.S. tax purposes, an aspect of the new provision that will likely cause significant challenges for taxpayers.

D. Section 901(m)

1. Background. The 2010 act created new section 901(m) to limit a taxpayer's ability to claim an FTC in connection with a covered asset acquisition. Section 901(m)(1) provides:

In the case of a *covered asset acquisition*, the *disqualified portion* of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets —

- shall not be taken into account in determining the credit allowed under [section 901(a)], and
- in the case of a foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), shall not be taken into account for purposes of section 902 or 960.²⁰

The term "covered asset acquisition" includes an acquisition in which a section 338(g) election is made. The term "disqualified portion" refers to the portion of the foreign tax on the target's post-acquisition income attributable to the amortization of the stepped-up basis of the target's assets, to the extent there was no basis step-up for foreign purposes. The limitation imposed by section 901(m) applies for purposes of computing a taxpayer's direct FTCs under section 901 and indirect FTCs under sections 902 and 960.

There is no legislative history to section 901(m), and the technical explanation by the Joint Committee on Taxation provides little insight to congressional concern underlying the provision.²¹ However, it seems clear from the operation of the provision that the objective of section 901(m) is to diminish the hyped FTC benefit produced by transactions that result in a basis step-up for U.S. tax purposes (and thus, increased depreciation and amortization deductions) but that do not result in a similar basis increase for non-U.S. purposes.

Section 901(m) generally applies to any covered asset acquisition occurring after December 31, 2010. However, a transition rule provides that the provi-

sion will not apply to any transaction in which the transferor and transferee are unrelated if the acquisition is (1) made under a written agreement that was binding on January 1, 2011, and at all times thereafter; (2) described in a ruling request submitted to the IRS on or before July 28, 2010; or (3) described on or before January 1, 2011, in a public announcement or in a filing with the SEC. The JCT estimated the provision would raise \$3.645 billion over the next 10 years.²²

2. Covered asset acquisition. Covered asset acquisitions include some transactions that result in the creation of additional asset basis for U.S. tax purposes but that do not create a similar basis increase for non-U.S. purposes, as a result of specific elections or characterizations under U.S. tax law. Section 901(m)(2) describes each of the following as a covered asset acquisition: (A) a QSP under section 338; (B) any transaction that is treated as an asset acquisition for U.S. tax purposes and as the acquisition of stock (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdictions (for example, the acquisition of the stock of an entity that is disregarded for U.S. tax purposes but is taxable as an entity in its jurisdiction of organization); and (C) any acquisition of an interest in a partnership that has an election in effect under section 754. Further, section 901(m)(2)(D) grants the Treasury secretary the authority to identify similar transactions in regulations.

Based on the statutory language, before further guidance from the government, it does not appear that transfers characterized as asset acquisitions for foreign tax purposes will constitute a covered asset acquisition for purposes of section 901(m), irrespective of whether the transaction is taxable or nontaxable for foreign tax purposes or taxable or nontaxable for U.S. tax purposes. In its report on section 901(m), the New York State Bar Association Tax Section has requested guidance on the issue.²³ The NYSBA report recommends that no transaction involving an actual transfer of legal ownership of assets from one party to another be identified in administrative guidance as a covered asset acquisition.²⁴ However, if Treasury rejects that approach, the NYSBA report recommends that administrative guidance limit the spectrum of actual asset transfers

²⁰Section 901(m)(1) (emphasis added).

²¹See JCT, "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), *Doc 2010-17846*, 2010 TNT 154-16 (the JCT report).

²²See JCT, "Estimated Budget Effects of the Revenue Provisions Contained in Senate Amendment No. 4575 to the Motion to Concur to the House Message on H.R. 1586, Scheduled for Consideration by the United States Senate on August 5, 2010," JCX-45-10 (Aug. 5, 2010), *Doc 2010-17490*, 2010 TNT 151-18.

²³See NYSBA Tax Section's Report on Section 901(m) (Jan. 28, 2011), *Doc 2011-2069*, 2011 TNT 20-82 (the NYSBA report).

²⁴*Id.* at 2 and 18-22.

that are characterized as covered asset acquisitions.²⁵ Among the categories the NYSBA report describes that may appropriately be subject to section 901(m) are transactions “structured principally to increase the effective foreign tax rate.”²⁶ As an example, the NYSBA report describes a “busted” section 351 transaction, whereby taxable asset sale treatment is obtained by virtue of a prearranged sale of the transferee corporation’s stock following a controlled asset transfer:

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. However, such a transaction often would be treated as a non-taxable transfer of assets for foreign tax purposes.²⁷

Thus, while the NYSBA report generally recommends that the definition not encompass any actual transfer of assets, it recognizes the possibility that actual asset transfers that are taxable from a U.S. perspective, but nontaxable from a foreign tax perspective, may be appropriately characterized as covered asset acquisitions. Presumably, forthcoming guidance from Treasury will address those issues.

3. Disqualified portion. To the extent of any covered asset acquisition occurring after the effective date, section 901(m) disallows the disqualified portion of any foreign taxes paid regarding that covered asset acquisition for a taxpayer’s computation of its allowable FTC under sections 901, 902, and 960.²⁸ The disqualified portion is the ratio of (1) the aggregate basis differences allocable to that tax year for all relevant foreign assets, divided by (2) the income on which the foreign tax is determined.²⁹ The aggregate basis differences are generally determined by comparing the adjusted basis in the foreign assets immediately after the covered acquisition with the adjusted basis of those assets before the covered asset acquisition (using U.S. tax principles).³⁰

Thus, section 901(m) has the effect of diminishing a taxpayer’s incremental FTC benefit created from a transaction that results in a step-up in basis for U.S. tax purposes but does not result in a similar basis

increase for non-U.S. tax purposes. However, any foreign taxes disallowed under section 901(m) are allowable as a deduction, which, as illustrated below, can provide an FTC benefit associated with making a section 338(g) election, even in the age of the covered asset acquisition rules of section 901(m).

4. Deduction for taxes paid, denied FTCs not included in section 78 gross-up. Section 901(m)(6) provides:

Taxes Allowed as a Deduction, Etc. — Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

Section 164(a)(3) permits a taxpayer to deduct from gross income foreign income taxes that are paid or accrued during the taxpayer’s tax year. However, section 275 denies a deduction for foreign taxes paid or accrued if the taxpayer opts to take a credit under section 901. Section 275 ensures that the payment or accrual of those taxes is not both deductible and creditable.

Section 901(m)(6) provides that section 275 does not apply to taxes that are not creditable because of the application of section 901(m). Thus, the provision allows those foreign taxes that are paid or accrued to be deductible in computing the target’s income. The JCT report clarifies that the foreign taxes otherwise denied as a credit are deductible under section 164(a)(3): “to the extent that a foreign tax credit is disallowed, the disqualified portion is allowed as a deduction to the extent otherwise deductible.”³¹ Thus, any foreign taxes paid or accrued by a corporation that are denied as a credit as a result of the operation of section 901(m) should be deductible in computing the target’s taxable income.

Generally, all taxes paid or accrued reduce a CFC’s E&P.³² Section 901(m) does not change that result for foreign taxes for which a credit is denied. Also, given that the starting point for a corporation’s computation of its E&P is generally taxable income,³³ foreign taxes paid or accrued that are deducted under section 164(a)(3) would reduce the E&P of the paying corporation. Therefore, all foreign income taxes paid by a target for which a section 338(g) election is made should reduce the

²⁵*Id.* at 2 and 22-26.

²⁶*Id.* at 24.

²⁷*Id.* (internal citations omitted).

²⁸Section 901(m)(1).

²⁹Section 901(m)(3).

³⁰Section 901(m)(3)(C).

³¹JCT report, *supra* note 21, at 16.

³²*See* reg. section 1.902-1(a)(9)(i) (post-1986 undistributed earnings of a CFC are reduced regardless of whether any shareholder is deemed to have paid any foreign taxes and regardless of whether any domestic shareholder chooses to claim an FTC under section 901(a) for the year of the distribution).

³³Reg. section 1.312-6(a).

target's post-acquisition E&P — even foreign income taxes that are not creditable under section 901(m).

Further, section 901(m)(6) provides that any foreign taxes not allowable as a credit by reason of section 901(m) will not be included in the amount required to be included under section 78. This provision ensures that any foreign taxes paid or accrued for which a credit is not allowed by reason of section 901(m) are consistently treated as a deduction.

The effect of allowing a deduction for the taxes paid and not requiring the denied credits to be included in the section 78 gross-up can provide an FTC benefit from making a section 338(g) election, albeit one that is diminished from the hyped benefit described below.

5. U.S. tax basis. Section 901(m) will likely add significant diligence obligations for U.S. taxpayers that purchase foreign targets if a section 338(g) election is made. U.S. taxpayers will have to determine the bases of the assets of the foreign target for U.S. tax purposes to determine the disqualified portion of any foreign taxes under section 901(m). To the extent the foreign target is not part of a group controlled by a U.S. parent, it is unlikely the U.S. tax bases would have ever been calculated under prior law. Thus, the U.S. purchaser will have an additional burden of determining the U.S. tax bases of the acquired assets immediately before the acquisition.

E. Making a Section 338(g) After Section 901(m)

1. FTC benefits.

a. Base example. Before the enactment of section 901(m), it was almost certain that a section 338(g) election would have been made on the purchase of FT in the base example. First, the basis step-up in FT's assets would have produced a hyped FTC benefit. Assume that in the year following the acquisition, FT earned \$15. If no section 338(g) election was made, FT's \$15 earnings would have been subject to an effective foreign tax rate of 30 percent. For purposes of this article, the "effective foreign tax rate" assumes that all the income earned by FT was repatriated in the year earned. As a result, the 30 percent effective foreign tax rate is calculated by starting with the \$15 of income earned by FT and then reducing that amount by the foreign taxes paid of \$4.50 (\$15 multiplied by 30 percent), resulting in after-tax income of \$10.50. If the \$10.50 were repatriated, section 78 requires the \$4.50 of foreign taxes paid to be added back, resulting in a U.S. income inclusion of \$15. That \$15 of income would be accompanied by \$4.50 of deemed-paid FTCs, resulting in an effective foreign tax rate of 30 percent on the income.

However, because of the section 338(g) election, FT's E&P would have been reduced by an additional \$5 of depreciation/amortization as a result of the U.S. basis step-up in FT's assets (\$50 of aggregate basis step-up divided by the average 10-year recovery period). Consequently, the effective foreign tax rate on FT's earnings would be 45 percent (before the application of section 901(m)). This hyped effective foreign tax rate is calculated by reducing FT's \$15 of income by \$9.50 (\$5 of additional depreciation and \$4.50 of foreign taxes paid), resulting in after-tax income of \$5.50. On repatriation of the \$5.50 of after-tax income, \$4.50 of foreign taxes is added back under section 78, causing a U.S. income inclusion of \$10. That \$10 of income would be accompanied by \$4.50 of deemed-paid FTCs, resulting in an effective tax rate of 45 percent on the income. This illustrates the hyped FTC benefit section 901(m) was apparently enacted to address.

Further, the section 338(g) election provided a fresh start for FT. FT's pre-acquisition tax history (for example, E&P and asset basis) was irrelevant for USP, and USP could begin its life with FT without the burden associated with determinations that would be complex at best and likely impossible under some circumstances. Also, since the seller is foreign, there would be no U.S. tax costs to the seller as a result of the section 338(g) election.

Following the enactment of section 901(m), is it desirable for a buyer to make a section 338(g) election for FT? The answer appears to be yes. First, an FTC benefit, while diminished from the pre-section 901(m) hyped benefit, follows from the election. Also, the additional benefits of a section 338(g) election remain.

Assume again that FT earns \$15 in the year following the acquisition. FT's E&P is reduced to \$10 by the \$5 of additional depreciation/amortization — section 901(m) does not prevent the additional depreciation/amortization deductions resulting from the basis step-up associated with a section 338(g) election. Further, as provided by section 901(m)(6), the full \$4.50 of foreign taxes paid by FT continue to be deductible for purposes of calculating FT's income and E&P, even though a portion of those taxes will not be creditable under section 901(m), thereby reducing FT's after-tax income to \$5.50.

Because of the operation of section 901(m), FT's foreign taxes that are creditable are reduced from \$4.50 to \$3. The \$1.50 reduction is the disqualified portion under section 901(m)(3), calculated by multiplying the foreign taxes (\$4.50) by: (a) \$5, representing the aggregate basis difference allocable to the post-acquisition year (\$50 of aggregate basis difference divided by an average recovery period of 10 years), divided by (b) \$15, the foreign income on which the \$4.50 foreign tax was based.

As discussed above, section 901(m)(6) provides that the gross-up amount described in section 78 does not include any foreign taxes that are not creditable by reason of section 901(m). Accordingly, on repatriation of the \$5.50 of after-tax income, only \$3 is added back, resulting in a U.S. income inclusion of \$8.50. The \$8.50 inclusion is accompanied by \$3 of deemed-paid FTCs (reduced from \$4.50 by reason of the application of section 901(m)), resulting in an effective foreign tax rate of 35.29 percent. That effective rate is certainly less than the pre-section 901(m) rate of 45 percent but more favorable than the 30 percent rate that would have resulted in the absence of a section 338(g) election.

Thus, while section 901(m) may have diminished the hyped FTC benefit that resulted from a section 338(g) election before the enactment of the provision, an FTC benefit remains because of the ability to deduct the foreign taxes paid from the E&P of the foreign target and exclude that amount from the gross-up inclusion.

b. Alternative 1: Lower foreign tax rate. The following alternative illustrates that making a section 338(g) election for FT when it is subject to a relatively low foreign tax rate results in an FTC benefit.

Assume the facts are the same as in the base example, except that FT is taxed in its local jurisdiction at a 15 percent rate rather than 30 percent. In the absence of a section 338(g) election, FT's \$15 of post-acquisition income would be subject to an effective foreign tax rate of 15 percent (\$12.25 of after-tax income, plus \$2.25 of foreign taxes added back under section 78, with \$2.25 of deemed-paid FTCs). Before the enactment of section 901(m), with a section 338(g) election, FT's post-acquisition earnings would have been subject to an effective foreign tax rate of 22.5 percent (\$7.75 of after-tax income, plus \$2.25 of foreign taxes added back under section 78, with \$2.25 of deemed-paid FTCs). After the enactment of section 901(m), with a section 338(g) election, FT's \$15 of post-acquisition income would be subject to an effective foreign tax rate of 16.22 percent (\$7.75 of after-tax income, plus \$1.50 of foreign taxes added back under section 78, with \$1.50 of deemed-paid FTCs).³⁴ Thus, the FTC benefit, although reduced from the pre-section 901(m) benefit, is greater than the result that would follow from not making a section 338(g) election.

³⁴As a result of section 901(m), the foreign taxes paid by FT that are creditable are reduced from \$2.25 to \$1.50. The \$0.75 reduction (the disqualified portion) is calculated by multiplying the foreign taxes (\$2.25) by (a) the aggregate basis difference allocable to the tax year (\$50/10 or \$5) over (b) the income on which the foreign tax was determined (\$15).

c. Alternative 2: Greater U.S. basis step-up. The following alternative illustrates the FTC benefit of making a section 338(g) election for FT when the amount of the aggregate U.S. stepped-up basis is increased.

Assume the facts are the same as in the base example, except that FT's U.S. tax basis in its assets before the acquisition is \$0 rather than \$50. In the absence of a section 338(g) election, FT's \$15 of post-acquisition income would be subject to an effective foreign tax rate of 30 percent (\$10.50 of after-tax income, plus \$4.50 of foreign taxes added back under section 78, with \$4.50 of deemed-paid FTCs). Before the enactment of section 901(m), with a section 338(g) election, the FT's post-acquisition earnings would have been subject to an effective foreign tax rate of 90 percent (\$0.50 of after-tax income, plus \$4.50 of foreign taxes added back under section 78, with \$4.50 of deemed-paid FTCs). After the enactment of section 901(m), with a section 338(g) election, FT's \$15 of post-acquisition income would be subject to an effective foreign tax rate of 75 percent (\$0.50 of after-tax income, plus \$1.50 of foreign taxes added back under section 78, with \$1.50 of deemed-paid FTCs).³⁵ Thus, the FTC benefit, although reduced from the pre-section 901(m) benefit, would be greater than the result that would follow from not making a section 338(g) election.

2. Additional benefits. As mentioned above, before the enactment of section 901(m), a section 338(g) election provided a fresh start for FT. Its pre-acquisition tax history (for example, E&P and asset basis) was irrelevant for USP, which could begin its life with FT without the burden associated with complex and sometimes impossible determinations.

Life is a bit more complicated after the enactment of section 901(m), because USP will need to determine the pre-acquisition U.S. tax basis of FT's assets to calculate the effect of section 901(m). However, the JCT report suggests that regulations may be issued that allow taxpayers to use the foreign tax basis of the assets of the foreign target to calculate the disqualified portion under section 901(m), thereby potentially easing this administrative burden. Specifically, the JCT report provides:

For purposes of determining the aggregate basis difference allocable to a taxable year, the term "basis difference" means, with respect to

³⁵As a result of section 901(m), the foreign taxes paid by FT that are creditable are reduced from \$4.50 to \$1.50. The \$3 reduction (the disqualified portion) is calculated by multiplying the foreign taxes (\$4.50) by (a) the aggregate basis difference allocable to the tax year (\$100/10 or \$10) over (b) the income on which the foreign tax was determined (\$15).

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.*³⁶

Commentators also have suggested allowing taxpayers to use the foreign tax basis of the assets of the foreign target to calculate the disqualified portion under section 901(m).³⁷ It is hoped that the IRS will provide for this in forthcoming regulations under section 901(m).

Nevertheless, the FMV basis and elimination of E&P remain attractive features of a section 338(g) election. For example, assume that FT owned the stock of USS and USP desires to integrate USS into its U.S. structure. If a section 338(g) election is made on the purchase of FT, FT will have an FMV basis in the stock of USS. Accordingly, FT could sell the USS stock to USP with no gain or loss to allow USP to integrate USS into its U.S. structure. That would have the effect of using foreign cash to fund the acquisition of the foreign components of FT and using U.S. cash to fund the U.S. components, while allowing for an efficient integration of each component into USP's U.S. and non-U.S. structure.

Alternatively, assume that USP (rather than CFC) purchased the stock of FT. Further, assume FT owns FS and USP wants to integrate FS into its foreign structure by transferring FS to CFC. If USP makes a section 338(g) election on the purchase of FT, FT will have an FMV basis in the shares of FS. Thus, FT could transfer the FS stock to CFC for cash, and an entity classification election could later be made to treat FS as a disregarded entity for U.S. tax purposes.

That transaction would likely be characterized as a section 368(a)(1)(D) reorganization, and because there is no gain inherent in the FS stock (as a result of the section 338(g) election made on the purchase of FT), FT should recognize no gain for U.S. tax purposes and USP should have no income inclusion under subpart F.³⁸

Under the base example with a foreign seller, the closing of the tax year of FT resulting from a section 338(g) election would prevent pre-acquisition subpart F income for the acquisition year from being included in USP's gross income. Subpart F income derived by a foreign-owned foreign target is otherwise allocated pro rata to the pre- and post-acquisition periods.³⁹

The above examples illustrate post-acquisition integration benefits in a post-section 901(m) world that will continue to cause taxpayers to make a section 338(g) election for the purchase of a foreign target corporation. Nevertheless, there may be some circumstances in which a section 338(g) election may not be desirable.

F. Conclusions

As discussed above, it generally has been advantageous for a U.S. company to make a section 338(g) election on the purchase of a foreign target. One of the benefits of that election was a hyped FTC benefit. While the benefit has been diminished by reason of section 901(m), there will generally remain an FTC benefit from the allowance of a deduction for those foreign taxes. That is generally true irrespective of the foreign tax rate the foreign target is subject to or the amount of built-in gain inherent in the foreign target's assets. Also, there are several other benefits, including flexibility in post-acquisition restructuring, that are achieved by reason of a section 338(g) election.

Thus, when evaluating the pros and cons of making a section 338(g) election, U.S. purchasers should continue to account for a potential FTC benefit even in the age of the covered asset acquisition rules of section 901(m).

³⁸Section 356(a) limits the recognition of boot in a reorganization (*i.e.*, the cash received by USP from CFC in the example) to the amount of gain inherent in the target stock (referred to as the "boot within gain" rule).

³⁹Section 951(a)(2)(A); reg. section 1.951-1(a). A buyer can also have subpart F income if the target was U.S. owned and therefore a CFC. The U.S. shareholder that holds the CFC's stock on the last day of the CFC's tax year must include in its gross income the section 951(a) amounts for the entire year. *See also* section 951(a)(2)(B) (the amount taxable to the buyer may be reduced by a portion of the section 1248 amount taxable to the seller).

³⁶JCT report, *supra* note 21, at 14 (emphasis added).

³⁷*See* NYSBA report, *supra* note 23, at 41-48.