OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

February 18, 1999

CC:DOM:FS:CORP
TL-N-3947-97

UILC: 304.02-04
1001.00-00

Number: **199925004**
Release Date: 6/25/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Application of I.R.C. §§ 304 and 1001

This Field Service Advice responds to your memorandum dated September 9, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Parent =

Sub1 =

Fsub1 =

Fsub2 =

Fsub3 =

Sub2	=
Buyer	=
Country X	=
Law1	=
§m	=
§n	=
Business	=
Entity	=
Charges	=
Asset1	=
Asset2	=
Enterprise	=
Account1	=
Official1	=
Official2	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=
$ii	=
$jj	=
$kk	=

$ll	=
$mm	=
$nn	=
$oo	=
$pp	=
$qq	=
$rr	=
$ss	=
$tt	=
$uu	=
$vv	=
$ww	=
$xx	=
$yy	=
$zz	=
$aaa	=
Value1	=
r%	=
s%	=
t%	=
u%	=
v%	=
w%	=
Year1	=
Year2	=
Year3	=

Year4	=
Year5	=
Year6	=
Year7	=
Date1	=
Date2	=
Date3	=
Date4	=
Date5	=
Month1	=
#p	=
#q	=

ISSUES:

1. Whether a transaction structured as a sale should be considered a redemption of stock for a distribution of property instead of a stock sale in which taxpayer can claim a loss.

2. Whether a loss claimed with respect to the sale of assets should be recognized, when the taxpayer has not established the amount realized or the adjusted basis of the assets sold.

CONCLUSION:

1. Although the transfer of the stock of Fsub3 between related corporations Fsub1 and Fsub2 was structured as a sale, it constitutes an acquisition by a related corporation under I.R.C. § 304(a)(1). Accordingly, the transaction is treated as a distribution in redemption of the stock of the acquiring corporation. Because the redemption does not qualify as an exchange under I.R.C. § 302(b), it is treated as a distribution under I.R.C. § 301. Thus, Fsub1 was not permitted to treat the transaction as a sale on which it could recognize a loss.

2. The loss attributable to the sale of assets should not be recognized because the taxpayer has not established the amount realized or the adjusted basis of the assets sold.

FACTS:

Parent is a domestic corporation that is the common parent of an affiliated group of corporations that filed consolidated returns during the tax years at issue. Fsub1 is a Country X corporation, and Sub1 is a domestic corporation. Both are wholly owned by Parent. Fsub1 owned r% and Sub1 owned s% of Fsub2, a Country X corporation.

Fsub3 is a Country X corporation, which was formed and wholly owned by Fsub1 in Year1. Fsub1 contributed assets including Asset1, as well as the balance of its cumulative Country X Charges, to Fsub3. The capital contributions were valued at $bb. In exchange, Fsub1 received shares of Fsub3 common stock.

The Country X corporations, Fsub1, Fsub2, and Fsub3, were not included as members of Parent's affiliated group under the consolidated return provisions. Sub1 is apparently a member of Parent's affiliated group and is included in Parent's consolidated federal income tax return.

Fsub3 engaged in the Business. It qualified as an Entity under the Country X Law1. Under Law1 §m generally, an Entity can renounce its Country X Charges in favor of a shareholder corporation.

In Year2, pursuant to an agreement between Fsub3 and Fsub1, Fsub1 contributed $cc to Fsub3 "in respect to" Fsub3's Charges. Fsub3 then renounced its Charges transferring them to Fsub1. From Year2 through Year5, Fsub1 contributed a total of $dd to Fsub3. At the same time, Fsub1 received $ee in renounced Charges from Fsub3. Fsub1 claimed the renounced Fsub3 Charges on its Country X tax returns for the years Year2 through Year5.

In Year3, Fsub2 purchased #p shares of Fsub3 common stock from Fsub1 for $ff. Fsub2 also acquired #q shares of preferred stock in Fsub3, paying $gg in total for its Fsub3 stock. Afterwards, Fsub1 and Fsub2 together owned Fsub3.

When Fsub2 acquired the Fsub3 stock, Fsub3 began to renounce its Charges to Fsub2 rather than to Fsub1. In total, Fsub2 received $hh in renounced Charges. Fsub2 made capital contributions to Fsub1, totaling $ii. Fsub2 reported the Charges on its Year3 through Year5 Country X tax returns.

Between Year2 and Year5, Fsub3 received a total of $jj in capital contributions from Fsub1 and Fsub2. It renounced to Fsub1 and Fsub2 a total of $kk in Charges over the same period. Fsub3's books do not track its renounced Charges or the relationship of the Charges to its activities or assets.

In Year5, two transactions occurred within a day of each other. On Date2, Fsub1 sold its Fsub3 stock to Fsub2 for $aa. Fsub1 reported a $zz loss on this sale for United States federal income tax purposes but did not report the loss on its Country X income tax return. Parent recorded this loss as a "Retained Earnings Adjustment," and the loss impacted Parent's foreign tax credits.

Fsub2 then dissolved Fsub3 on Date3. Fsub3's assets and liabilities were transferred to Fsub2 pursuant to an Assignment and Assumption Agreement. Fsub2 did not report a gain or loss on its stock when it liquidated Fsub3.

After liquidating Fsub3, Fsub2 sold Fsub3's assets pursuant to various agreements. Fsub2 at first claimed it sustained a $mm loss in Year5 from these sales. Parent subsequently stated that the loss was attributable to the sale of one asset for Year5, that is, its v% interest in Enterprise. To determine its loss for Year5, Parent took Fsub3's tax basis.

With respect to the sale of Fsub3's assets, and specifically with respect to the Enterprise sale, the Service asked Parent to substantiate the claimed losses including providing documents to support Fsub2's tax basis in each asset sold and the asset's sale price.

Among the documents provided in response was a Date1 letter from Official1 of Sub2, to Official2 ("Official2 letter"). The letter states that as of Date5, the market value of Fsub3 was Value1, and attached to the letter was a list of assets owned by Fsub3 on Date1.

Parent asserts the fair market value of the assets received from Fsub3 was equal to the third party sale prices as stated in the Official2 letter. The letter indicates that Enterprise is worth $nn plus a share of Asset2 estimated to be worth $pp. The Asset Sale Agreement between Fsub3 and Buyer for Enterprise similarly reflects a selling price of $nn plus a percentage of the value of Asset2. Additionally, Parent has indicated that certain liabilities were assumed as part of the sale of the asset yet did not clarify whether the liabilities were included in the amount realized.

Parent also provided a spreadsheet showing Fsub2's Tax Gain/Loss - Abnormal Retirements for Year5 and Year6, and Capital Gains for Year7. According to the spreadsheet, Enterprise was sold for only $qq, t% of the amount shown in both the

Official2 letter and the sales agreement. The spreadsheet also indicates that Fsub3's adjusted tax basis in Enterprise was $rr (investment of $ss adjusted by $tt). The loss resulting from its sale was $uu ($rr - $qq). According to the same spreadsheet, the remaining $vv of the claimed $mm loss was connected to Account1 depreciable property and inventory.

Fsub3 sold the depreciable property in question in Year4 prior to its liquidation. With respect to the inventory, the facts are not clear. Fsub3's income and expense statements show no ending inventory, but Fsub2's books show that Fsub3 inventory valued at $ww was transferred to the books of Fsub2's minerals branch at the end of Year5. The spreadsheets show that the inventory sold was worth $xx.

Parent has not substantiated Fsub3's basis in its assets at the time of liquidation nor has it substantiated the amount received for those assets when they were sold. Parent has also not explained the nature of the Charges which Fsub1 renounced and how those renounced Charges impact the basis of the assets sold. The International Examiner has made numerous requests for this information. Parent has not provided all the requested documents necessary to make the proper determinations. Parent has stated that some documents could not be located.

Based on the two transactions which occurred on two days in Month1 Year5, Fsub1 and Fsub2 together claimed total losses of $yy. This is more than their combined capital contribution of $jj to Fsub3. These losses impact Parent's available foreign tax credit. Fsub2 included the $mm loss when Parent computed allowable foreign credits on a dividend paid to Fsub1. Fsub1 claimed the stock sale loss when computing its net income and increased the foreign tax credit available to Parent on receipt of Fsub1's dividend. The Service disallowed both losses.

ISSUE 1. FSUB1'S SALE OF FSUB3 STOCK TO FSUB2

<u>LAW AND ANALYSIS</u>

A. <u>Controlled Foreign Corporations and I.R.C. § 1248</u>

A controlled foreign corporation ("CFC") is any foreign corporation in which United States shareholders own (or are considered as owning) more than 50 percent of either: "(1) the total combined voting power of all classes of stock of such [foreign] corporation entitled to vote; or (2) the total value of the stock of such [foreign] corporation." I.R.C. § 957(a). A "United States shareholder" is any U.S. person who owns (or is considered as owning) 10 percent or more of the total combined voting power of all classes of voting stock of such foreign corporation. *See* I.R.C. § 951(b). A U.S. person "owns" stock in a foreign corporation, if the stock is either

(1) directly owned by the U.S. person, *see* I.R.C. § 958(a)(1)(A); (2) owned through a foreign corporation, *see* I.R.C. § 958(a)(1)(B); or (3) owned constructively through related corporations, *see* I.R.C. § 958(b).

If a U.S. shareholder (or a U.S. person who was a U.S. shareholder of a CFC within the prior 5 years) sells or exchanges stock in a foreign corporation, "then the gain recognized on such sale or exchange of such stock shall be included as a dividend, to the extent of the earnings and profits of the foreign corporation attributable to such stock which were accumulated after December 31, 1962, and during the period the stock was held by such person while such corporation was a [CFC]." I.R.C. § 1248(a). Section 1248(a) is triggered upon a recognition transaction.

In the instant case, Fsub1, Fsub2 and Fsub3 were CFCs before and after the transfer of the Fsub3 stock from Fsub1 to Fsub2. Parent and Sub1 were U.S. shareholders of those CFCs.

B. Application of I.R.C. § 304

Under I.R.C. § 304(a)(1), if one or more persons are in control of each of two corporations and one of the corporations acquires stock in the other from a controlling person in return for property, then the property paid for the stock is treated as a distribution in redemption of the acquiring corporation's stock. The tax treatment of the redemption is subject to the rules of I.R.C. § 302 to determine whether it is treated as an exchange or as a distribution of property under I.R.C. § 301. To the extent the redemption is treated as a distribution of property subject to I.R.C. § 301, the stock so acquired is treated as having been transferred by the person from whom acquired, and as having been received by the acquiring corporation, as a contribution to the capital of the acquiring corporation.[1/]

For purposes of I.R.C. § 304, "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. I.R.C. § 304(c)(1). Pursuant to I.R.C. § 304(c)(3), the constructive ownership rules of I.R.C. § 318(a) are applicable, with certain modifications, for purposes of determining control. In particular, the constructive ownership rules of sections

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[1/] Effective for distributions or acquisitions after June 8, 1997, this capital contribution provision was amended to provide that in a distribution subject to I.R.C. § 301, the transferor and acquiring corporations are treated as if the transferor had transferred the stock to the acquiring corporation in a transaction to which I.R.C. § 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

318(a)(2)(C) (involving attribution from a corporation) and 318(a)(3)(C) (involving attribution to a corporation) are applied by substituting “5 percent” in lieu of “50 percent” for purposes of determining control.

In the case of a section 304 redemption that is treated as a distribution under I.R.C. § 301, the amount treated as a dividend is determined as if the property were distributed first by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits.

In the instant case, Fsub1 directly owned u% of the Fsub3 common stock prior to the sale of Fsub3 to Fsub2. In addition, through its r% ownership of Fsub2 and Sub1's s% ownership of Fsub2, which was attributed to Fsub1 under I.R.C. § 304(c), Fsub1 indirectly owned the remaining Fsub3 common stock and all of the Fsub3 preferred stock. Thus, Fsub1 owned all of the Fsub3 common and preferred stock before the sale to Fsub2.

Similarly, Fsub1 also controlled Fsub2 inasmuch as it directly owned r% of Fsub2 and owned by attribution (through Parent) the s% of Fsub2 common stock held by Sub1. Accordingly, because Fsub1 was in control of both Fsub2 and Fsub3, the $aa paid by Fsub2 to Fsub1 is treated by section 304 as a distribution in redemption of Fsub2's stock.

C. Treatment of the Deemed Redemption.

The treatment of the amount received in the deemed redemption of Fsub2 stock is determined in accordance with the rules of I.R.C. § 302. The amount received in the deemed redemption is treated as a distribution in part or full payment in exchange for the stock if the redemption satisfies any one of 4 tests specified in I.R.C. § 302(b): (1) the distribution is not essentially equivalent to a dividend; (2) the distribution is substantially disproportionate with respect to the shareholder; (3) the redemption is in complete termination of all the shareholder’s stock in the corporation; or (4) the distribution is to a noncorporate shareholder and is in partial liquidation of the distributing corporation. If none of the tests is satisfied, I.R.C. § 302(d) provides that the redemption is treated as a distribution of property under I.R.C. § 301.

In a transaction subject to I.R.C. § 304(a), the determination of whether the redemption is treated as an exchange under the rules of I.R.C. § 302(b) is made by reference to the issuing corporation (i.e., the corporation whose stock is transferred). In applying the constructive ownership rules of I.R.C. § 318(a) with respect to I.R.C. § 302(b), sections 318(a)(2)(C) (involving attribution from a corporation) and 318(a)(3)(C) (involving attribution to a corporation) are applied without regard to the 50 percent limitation contained in those provisions.

In the instant case, Fsub1 owned all of the stock of Fsub3 immediately before the transfer to Fsub2, u% directly and the remaining w% by attribution. After selling its Fsub3 stock to Fsub2, Fsub1 continued to own all of the common stock of Fsub3 under the applicable constructive ownership rules as a result of its r% ownership of Fsub2 and its constructive ownership of Sub1's s% ownership of Fsub2. Thus, for purposes of applying the tests under I.R.C. § 302(b), Fsub1's ownership interest in Fsub3 did not change as a result of the transfer of the Fsub3 stock to Fsub2.

As discussed in your request, the redemption in this case does not satisfy any of the section 302(b) tests:

1. Inasmuch as Fsub1 retained the same ownership interest in Fsub3 after the stock sale as it held before, the deemed redemption under I.R.C. § 304 did not result in a "meaningful reduction" of Fsub1's ownership of Fsub3. *Davis v. Commissioner*, 397 U.S. 301, 313 (1970); *see Coates Trust v. Commissioner*, 55 T.C. 501 (1970), *aff'd*, 480 F.2d 468 (9th Cir.), *cert. denied*, 414 U.S. 1045 (1973). Thus, the deemed redemption was essentially equivalent to a dividend under I.R.C. § 302(b)(1).

2. Prior to selling its Fsub3 stock to Fsub2, Fsub1 owned, directly and indirectly, all of the voting stock of Fsub3, as discussed above. After the sale, Fsub1 no longer held any direct ownership of Fsub3 voting stock but, through application of the constructive ownership rules, it still indirectly owned all the Fsub3 voting stock. Accordingly, the deemed redemption was not substantially disproportionate with respect to Fsub1 under I.R.C. § 302(b)(2).

3. Similarly, under the constructive ownership rules for I.R.C. § 302, the deemed redemption did not terminate Fsub1's interest in Fsub3 under I.R.C. § 302(b)(3).

4. The partial redemption test under I.R.C. § 302(b)(4) applies only where the redeemed shareholder is not a corporation. *See* I.R.C. § 302(b)(4)(A). Because Fsub1 is a corporation, this test is not applicable in this case.

Thus, the deemed redemption fails to qualify for treatment as an exchange under I.R.C. § 302(a) and accordingly is treated under I.R.C. § 302(d) as a distribution of property subject to I.R.C. § 301. In particular, pursuant to I.R.C. §§ 301(c)(1) and

304(b)(2), it is treated as a dividend to Fsub1, to the extent of the combined earnings and profits of Fsub2 and Fsub3.

In accordance with I.R.C. § 304(a)(1), as applicable in Year5, the Fsub3 stock is treated as having been transferred by Fsub1 as a contribution to the capital of Fsub2. Thus, Fsub1's basis in the Fsub3 stock should be added to its basis in the stock of Fsub2, and Fsub2 should take a carryover basis in the Fsub3 stock. In particular, while Fsub1's contribution to the capital of Fsub2 resulted in these basis adjustments, it was not a recognition event. Accordingly, Fsub1 did not recognize any gain or loss on the transaction.

D. I.R.C. § 367

The section 367(b) regulations address the case of a foreign corporation's transfer of stock in a controlled foreign corporation in an exchange under section 351. In particular, Temp. Treas. Reg. § 7.367(b)-8(c) provides:

> If the transferor corporation transfers stock in a foreign corporation of which there is a United States shareholder immediately before the exchange, and the transferor receives stock –
>
> > (1) Of a controlled foreign corporation as to which all United States shareholders of the transferor corporation remain United States shareholders, § 7.367(b)-9 shall apply.

This provision does not require that the U.S. shareholder recognize section 1248 gain on the exchange. Instead, it requires the foreign corporations involved to apply the earnings and profits attribution rules contained in Temp. Treas. Reg. § 7.367(b)-9 so that any section 1248 gain is preserved and attributable to the U.S. shareholder that succeeds to the untaxed earnings and profits of the controlled foreign corporations.

In the instant case, Temp. Treas. Reg. § 7.367(b)-8(c)(1) would apply if Fsub1's transfer of the Fsub3 stock to Fsub2 is treated as an exchange under I.R.C. § 351. Parent and Sub1 were U.S. shareholders of Fsub1, Fsub2 and Fsub3 before and after the transfer of the Fsub3 stock. Therefore, Temp. Treas. Reg. § 7.367(b)-8(c)(1) would apply because Fsub1 (the transferor) transferred stock in Fsub3 (a foreign corporation of which Parent and Sub1 were U.S. shareholders immediately before the exchange), and Fsub1 received in exchange stock of Fsub2 (a controlled foreign corporation in which Parent and Sub1 remain U.S. shareholders). However, Temp. Treas. Reg. § 7.367(b)-8(c)(1) would not require that either Parent or Sub1 recognize section 1248 gain on the exchange. Instead, that provision would require

Parent, Sub1, Fsub1 and Fsub2 to apply the earnings and profits attribution rules contained in Temp. Treas. Reg. § 7.367(b)-9 so that any section 1248 gain is preserved and will be attributable to the U.S. shareholder that succeeds to the untaxed earnings and profits of the controlled foreign corporations.

For purposes of determining how I.R.C. § 367 applies to this transaction (see discussion above), we note that Fsub1's contribution of the Fsub3 stock to Fsub2 was not an exchange described in I.R.C. § 351. In order for a transaction to qualify under I.R.C. § 351, the transferors must have control (within the meaning of I.R.C. § 368(c)) immediately after the exchange. *See* I.R.C. § 351(a). The term "control" is defined by I.R.C. § 368(c) to mean "the ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." For purposes of I.R.C. §§ 351(a) and 368(c), ownership must be direct since the attribution rules of I.R.C. § 318(a) do not apply. *See* Rev. Rul. 56-613, 1956-2 C.B. 212; Rev. Rul. 78-130, 1978-1 C.B. 114.

Before and immediately after transferring the Fsub3 stock to Fsub2, Fsub1 directly owned only r% of the stock of Fsub2. Thus, Fsub1 did not "control" Fsub2 immediately after contributing the Fsub3 stock, and the transfer did not qualify as an exchange described in section 351. As a result, Fsub1's transfer of the Fsub3 stock is simply a contribution to the capital of Fsub2 under section 304(a)(1). There are no provisions under section 367(b) that expressly apply to capital contributions as such, and the normal rules pertaining to a capital contribution would apply. Accordingly, Fsub1 should not recognize a loss on the transfer.

In any event, section 367 should not cause an income inclusion or loss recognition on the transfer of the Fsub3 stock to Fsub2 under section 304, irrespective of whether the transfer of the stock is treated as a capital contribution or an exchange under section 351. Section 367(b) states that "[i]n the case of any exchange described in section . . . 351, in connection with which there is no transfer or property described in [section 367(a)(1)], a foreign corporation shall be considered to be a corporation, except to the extent provided in regulations." I.R.C. § 367(b). The rule for transactions described in section 367(b) is that a foreign corporation will be considered to be a corporation for purposes of the applicable nonrecognition provisions, unless regulations provide otherwise.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

1. Because Fsub1 owned (within the meaning of section 318) 100 percent of the stock of Fsub2 immediately after transferring the Fsub3 stock, Fsub1's contribution of the Fsub3 stock to the capital of Fsub2 could arguably be treated under I.R.C.

§ 367(c)(2) as an exchange of such property for the stock of Fsub2 equal to the fair market value of the Fsub3 stock. The taxpayer therefore may argue that section 367(c)(2) triggers the claimed loss in the Fsub3 stock. However, we do not believe that Congress intended section 367(c)(2) to be used to trigger losses in a situation such as this, involving a transfer from one foreign corporation to another foreign corporation. *See* H. R. Rep. No. 91-1762, at 4-5 (1970). Because this issue has not previously been litigated in the context of a foreign-to-foreign transfer, we suggest that you further coordinate with the National Office in the event taxpayer raises this issue.

2. In analyzing the transaction at issue, we initially considered whether the loss could be disallowed on the ground that the transfer of the Fsub3 stock and the liquidation of Fsub3 into Fsub2 constituted an integrated transaction that would qualify as a reorganization under I.R.C. § 368(a)(1)(D). As a party to such a reorganization, Fsub1 would not recognize any loss on the transaction. *See* I.R.C. § 362(a). Although the transaction would appear to qualify as a "D" reorganization, taking into account I.R.C. § 368(a)(2)(H), the available facts indicate that there were binding contracts to sell all of Fsub3's assets at the time of the transfer. In that case, the continuity of business enterprise requirement of Treas. Reg. § 1.368-1(d) would not be satisfied. [redacted]

3. We have also considered whether I.R.C. § 267(f) would apply to the loss claimed by Fsub1 on the transfer of the Fsub3 stock to Fsub2. Because Fsub1, Fsub2 and Fsub3 were all members of a controlled group of corporations within the meaning of I.R.C. §§ 267(f)(1) and 1563(a), section 267(f)(2) would generally apply to defer any loss to which Fsub1 might otherwise be entitled on the transfer of the Fsub3 stock until the Fsub3 stock is transferred outside the controlled group and there would be recognition of the loss under consolidated return principles (or until such other time as prescribed in regulations).

The central question, however, is whether the subsequent liquidation of Fsub3 into Fsub2 would trigger the recognition of such a loss. The final regulations adopted in 1995 would not treat Fsub3's liquidation as a triggering event. *See* Treas. Reg. § 1.267(f)-1(c)(1)(iv) (selling corporation's loss deferred until seller and buyer are no longer in a controlled group relationship). However, this regulation would apply only to transactions occurring in Fsub1's tax years beginning on or after July 12, 1995 (*see* § 1.267(f)-1(k)(1)) and therefore does not apply to the transaction in this case. Instead, Fsub1's transfer of the Fsub3 stock to Fsub2 would be governed by former Temp. Treas. Reg. § 1.267(f)-1T(c), which provided that “the rules for deferred intercompany transactions in § 1.1502-13 of the consolidated return regulations apply under section 267(f)(2) to the deferral and restoration of loss on the sale of property directly or indirectly between [members of a controlled group].” Although the intercompany rules of Treas. Reg. § 1.1502-13 that were applicable in Year5 do not expressly address the situation arising in the instant case, our current view is that the liquidation of Fsub3 would be treated as a restoration event under those regulations. Under this view, the liquidation of Fsub3 would also be a restoration event under section 267(f), and Fsub1 would be permitted to recognize any loss on the transfer of the Fsub3 stock when Fsub3 liquidated. Thus, it appears that section 267(f) would not preclude Fsub1 from taking such a loss in Year5. However, the application of section 267(f) is not a significant factor under our primary position set forth above, inasmuch as Fsub1 would not recognize any loss. In the event the taxpayer raises the section 367(c)(2) argument discussed above, it may be appropriate to investigate further whether section 267(f) would preclude Fsub1 from recognizing any loss in Year5 on the transfer of the Fsub3 stock.

4. The taxpayer has taken the position that the Fsub3 stock transferred to Fsub2 by Fsub1 had a fair market value of only $aa. Although we have assumed that value to be correct for purposes of responding to your request, we note that the Official2 letter suggests the fair market value of Fsub3 may have been greater than $aa. If so, then the Fsub1 would be treated as contributing the additional amount to the capital of Fsub2. [redacted].

ISSUE 2. REPORTED LOSSES ON ASSET SALES

LAW AND ANALYSIS:

Fsub1 and Fsub2 are both foreign corporations, but United States federal income tax law would apply to the sale transactions in question for the purposes of determining the impact of the transactions on Parent's United States federal income tax return.

The loss from a sale shall be the excess of the adjusted basis provided in section 1011 for determining loss, over the amount realized. I.R.C. § 1001(a).

A. AMOUNT REALIZED

The amount realized refers to the amount of economic benefit received by a taxpayer when he disposes of property. Treas. Reg. § 1.1001-1(a). It includes such items as cash received, the fair market value of property received, the amount of liabilities from which the taxpayer is relieved, and any other benefits inuring to the taxpayer as a result of the disposition. I.R.C. § 1001(b); Treas. Reg. § 1.1001-1(a) and § 1.1001-2(a)(1). A taxpayer must verify the amount realized. *See Willow Terrace Development Co. v. Commissioner*, 345 F.3d 933 (5th Cir. 1965); *Correra v. Commissioner*, 1997-356; *Bianco v. Commissioner*, T.C. Memo. 1982-186.

Parent has not provided the exact sales price for the assets. For example, the Asset Sales Agreement shows the price for Enterprise is $nn plus v% of all Asset2 held by Enterprise on Date4. The fair market value of Asset2 has not been provided. Additionally, the spreadsheet on which the loss was calculated reflects a sales price of much less than the amount shown in the Asset Sales Agreement. Lastly, certain liabilities assumed as part of the sale may not have been included in the amount realized, as they should have been. *See Fisher Companies, Inc. v. Commissioner*, 84 T.C. 1319 (1985), 806 F.2d 263 (9th Cir. 1985); *Emmons v. Commissioner*, T.C. Memo. 1998-173; *Chilingirian v. Commissioner*, T.C. Memo. 1986-463.

B. ADJUSTED BASIS

The basis of property used for computing the loss from a sale is normally its cost, although another basis may be substituted under subchapter C (relating to corporate distributions and adjustments). I.R.C. § 1012. In either case, the basis must be adjusted as provided by section 1016. I.R.C. § 1001(a) and § 1011(a).

The taxpayer must verify its basis. *See Hodgkins v. Commissioner*, T.C. Memo. 1996-53; *McDade v. Commissioner*, T.C. Memo. 1987-56. However, in certain circumstances, where it is clear capital expenditures have been made, the Tax Court may apply the rule of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930), and allow an estimate of those expenditures. *See Mayes v. Commissioner*, 21 T.C. 286 (1953), *acq.* 1954-1 C.B. 5; *Bowden v. Commissioner*, T.C. Memo. 1996-318.

Basis is decreased by the amount of depreciation, depletion, and amortization, exhaustion, wear and tear, and obsolescence allowed or allowable in prior years. I.R.C. § 1016(a)(2); Treas. Reg. § 1.1016-3(a)(1). Additionally, under section 1016(a)(9), basis of real property is decreased by the amount of expenditures for development or exploration of mines or mineral deposits on that property allowed as a deduction that causes a reduction in the taxpayer's income tax liability, but not less than the amount allowable as a deduction.

As noted in your memorandum, Fsub2's basis in the Fsub3 assets will be the same as Fsub3's basis in the assets, pursuant to section 334(b). If the basis is a substituted basis, then under section 1016(b), the adjustments provided in section

1016(a) are made after first making the adjustments attributable to the period the property was held by the transferor. *See also* Treas. Reg. § 1.1016-10. Thus, any adjustments attributable to the period the property was held by Fsub3 should be made prior to, and along with, any adjustments attributable to the period Fsub2 held the assets.

Fsub3 reported total deductions in the amount of $ll from Year2 through Year5. Included in this amount are depreciation expenses totaling $oo and depletion expenses totaling $aaa. Both these amounts may contain potential basis adjustments. Even if the depreciation or depletion was not deducted but was "allowable," it must be used to adjust the cost basis of property. *United States v. Ludey*, 274 U.S. 295 (1927); *Hinckley v. Commissioner*, 410 F.2d 937 (8th Cir. 1969); *Hodgkins v. Commissioner*, T.C. Memo. 1996-53.

Fsub3 also renounced Charges in the total amount of $kk. There are indications under Country X law that renounced Charges could result in basis adjustments. *See, e.g.,* LawX §n. Parent has stated that the adjusted basis for the asset it sold in Year5 reflects the renounced Charges amount but has not provided any records to support this claim.

Parent also relies upon GCM 39,367 (June 3, 1985), which concluded that payments for similar renounced deductions were not payments for value but were either capital contributions or dividends or both, depending on the structure of the transaction. In our view, the GCM does not address the issue here, i.e., potential adjustments to the basis of the assets to which the renounced deductions pertain.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.

By:
STEVEN J. HANKIN
Acting Chief
Corporate Branch

cc: Regional Counsel CC:
Assistant Regional Counsel (LC) CC: