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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR: Mike Picariello
IFASP

FROM: Phyllis Marcus
CC:INTL:Br2, Chief

SUBJECT: Avoidance of Subpart F Income by Electing to Check the Box as a Disregarded Entity

This Technical Assistance responds to your memorandum dated May 14, 1999. Technical Assistance is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

Facts:

This memorandum responds to your request about whether an upper-tier controlled foreign corporation ("FC1") may convert what otherwise would be subpart F income, related to the sale of stock of a lower-tier controlled foreign corporation ("FC2"), into non-subpart F income by either liquidating FC2 or treating FC2 as a disregarded entity pursuant to the "check the box" election set forth in Treas. Reg. § 301.7701-3. Specifically, U.S. Co. is the shareholder of FC1, a holding company that owns all of the stock of FC2, an operating entity that owns various assets. Until the date FC2 liquidated, or elected to be treated as a disregarded entity, both FC1 and FC2 operated as two separate corporations. The purpose for liquidating FC2, or making the disregarded entity election, was so FC1 could treat a transaction, that would otherwise be a sale of FC2 stock, as a sale of FC2's assets.

You request our views on this issue based on the following fact patterns:

1. FC2 elects to check the box, or liquidates into FC1, immediately prior to the sale transaction.

2. FC2 elects to check the box, or liquidates into FC1, at the time FC1 enters into a contract for sale, but the actual sale transaction is not consummated for a period of time (e.g. 3 months or less).

Conclusion:

Pursuant to Treas. Reg. §§ 1.954-2(e)(3) and 1.954-2(a)(3), the gain from the sale of an asset will be excluded from subpart F income only when the asset was used, or held for use, in a trade or business by the controlled foreign corporation for more than one-half of the time during which such corporation had the asset prior to the sale transaction. In both fact patterns, FC1 did not use or hold the assets for use in its trade or business. FC1 had no expectation of continuing or engaging in activities related to a particular field of endeavor since it had entered into a commitment to sell FC2, or its assets, on or before FC2 became a branch of FC1.

Law and Analysis:

Section 951(a) requires the U.S. shareholder of a controlled foreign corporation to include in gross income its pro rata share of the corporation's subpart F income for the taxable year. Section 952(a) defines subpart F income to include, inter alia, foreign base company income as determined under section 954(a). Section 954(a) defines five categories of foreign base company income, one of which is foreign personal holding income ("FPHCI") as defined in section 954(c). Specifically, section 954(c) states in pertinent part that:

> (1) In General. — For purposes of subsection (a)(1), the term "foreign personal holding company income" means the portion of the gross income which consists of ...
>
> > (A) Dividends, Etc. — Dividends, interest, royalties, rents, and annuities.
> >
> > (B) Certain Property Transactions. — The excess of gains over losses from the sale or exchange of property —
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> > > (i) which gives rise to income described in subparagraph (A) ...,
> > >
> > > (ii) which is an interest in a trust, partnership, or REMIC, or
> > >
> > > (iii) which does not give rise to any income.
> > >
> > > Gains and losses from the sale or exchange of any property which, in the hands of the controlled foreign corporation, is property described in section 1221(1) shall not be taken into account under this subparagraph.[1]

Therefore, any gain recognized from property transactions enumerated in section 954(c)(1)(B) (i) through (iii) is FPHCI. In general, gain recognized by FC1 on the sale of FC2 stock is treated as FPHCI under section 954(c)(1)(B)(i) because that

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[1] Section 1221 prescribes the types of property that are not considered capital assets. Subsection (1) provides that capital assets do not include property that is inventory or "primarily held for sale to customers in the ordinary course of the taxpayer's trade or business".

gain is derived from the sale or exchange of property which gives rise to certain prescribed income (e.g. dividends). *See also* Treas. Reg. § 1.954-2(e)(1)(i)(A).

However, with respect to the sale of assets, such transaction is governed by section 954(c)(1)(B)(iii) as a property transaction which does not give rise to income. The tax consequences of the resulting gains depend on the character of the assets that are described in the regulations under section 954(c)(1)(B)(iii). Treas. Reg. § 1.954-2(e)(3) describes the types of property whose gain is FPHCI, and excludes from FPHCI gain from those assets that are used, or held for use, in a trade or business. Specifically, Treas. Reg. § 1.954-2(e)(3) states, in relevant part,

> (3) *Property that does not give rise to income*. Except as otherwise provided in this paragraph (e)(3), for purposes of this section, the term *property that does not give rise to income* includes all rights and interest in property (whether or not a capital asset) including, for example, forwards, futures and options. Property that does not give rise to income shall not include —
>
> (ii) Tangible property (other than real property) used or held for use in the controlled foreign corporation's trade or business that is of a character that would be subject to the allowance for depreciation under section 167 or 168 and the regulations under those sections (including tangible property described in § 1.167(a)-2); [[2]]
>
> (iii) Real property that does not give rise to rental or similar income, to the extent used or held for use in the controlled foreign corporation's trade or business;
>
> (iv) Intangible property (as defined in section 936(h)(3)(B)), goodwill or going concern value, to the extent used or held for use in the controlled foreign corporation's trade or business;

To determine whether the property was used, or held for use, in a particular fashion by the controlled foreign corporation, Treas. Reg. §1.954-2(a)(3) sets forth a specific time frame for examining the manner in which the property was so used or held. Treas. Reg. §1.954-2(a)(3) states:

> (3) *Changes in the use or purpose for which property is held* — (i) *In general*. Under paragraphs (e), (f), (g) and (h) of this section, transactions in certain property give rise to gain or loss included in the

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[2] For the property to be subject to an allowance for depreciation under section 167 or 168, the property must be used in a trade or business, or held for the production of income.

> computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. The use or purpose for which the property is held is that use or purpose for which it was held for more than one-half of the period during which the controlled foreign corporation held the property prior to the disposition.

Based on the foregoing regulations, the gain from the sale of an asset will be excluded from FPHCI, and thus from subpart F income, only if the asset was used, or held for use, in a trade or business by the controlled foreign corporation for more than one-half of the time during which such corporation held the asset prior to the sale transaction. Therefore, the key issues for determination are (1) whether FC1 was engaged in a trade or business, and (2) whether the assets are used, or held for use, in that trade or business for the requisite period.

"The phrase 'trade or business,' as used in the Federal tax laws, has a 'common and well-understood connotation as referring to the activity or activities in which a person engages for the purposes of earning a livelihood." Hamrick v. Commissioner, T.C. Memo. 1979-72, 38 T.C.M. (CCH) 305, 308(1979). "[T]he taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." Keenan v. Commissioner, T.C. Memo 1998-388, *quoting* Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987). "[T]he lack of continuity and frequency of activity in a particular field of endeavor is a strong indicia that a taxpayer is not engaged in a trade or business in that field." Reese v. Commissioner, 615 F.2d 226, 230 (5th Cir. 1980). "[A] single transaction ordinarily will not constitute a trade or business when the taxpayer enters into the transaction with no expectation of continuing in the field of endeavor." Id.

For instance, in Reese supra, the taxpayer recognized an ordinary loss upon the disposition of a partially completed building, and claimed that such loss was incurred in connection with his trade or business. The taxpayer argued that in addition to being the financial investor for the project, he also acted as the builder, developer and general contractor. Prior to this project, the taxpayer had never been involved in a trade or business as a builder, developer or general contractor. The taxpayer developed the property solely for the purpose of providing his corporation with a new manufacturing facility. The Court of Appeals determined that:

> [t]he project was clearly an isolated, non-recurring venture. [Taxpayer] cannot be considered to be engaged in the trade or business of 'building, developing and general contracting' with respect to the venture because there was neither prior or subsequent activity on his part in this field of endeavor, nor an intention to devote his time and

> effort in the future to activities in this field. Reese v. Commissioner, 615 F.2d at 231.

For property to be considered "used in a trade or business, [the] asset must [also] be devoted to a taxpayer's business or acquired with a view to its future business use." Ouderkirk v. Commissioner, T.C. Memo. 1977-120, 36 T.C.M. (CCH) 526, 529 (1977); *see also* Azar Nut Co. v. Commissioner, 94 T.C. 455, 463 (1990), *aff'd* 931 F.2d 314 (5th Cir. 1991). In Ouderkirk, supra, the taxpayer received a sawmill and 7,700 acres of timberland upon liquidation of a corporation. The taxpayer contributed both properties to a partnership in exchange for a 50% ownership interest, and operated the sawmill business for eight years. During this period, the partnership cut some of the timber that was scattered on the 7,700 acres. The taxpayer sold the sawmill at a loss, and treated the transaction as a sale of property used in a trade or business that is subject to an ordinary loss deduction under section 1231. On this same transaction, the taxpayer also sold the 7,700 acres of timberland at a gain, and treated the timberland as a sale of capital asset. The taxpayer argued that the timberland was a disposition of property held for investment purposes, while the Service claimed that the land and timber were business assets held for use in taxpayer's sawmill operations. As such, the timber and land constituted property used in a trade or business.

The court held that "whether an asset is used in a trade or business or is instead an investment, the taxpayer's intent in acquiring the property, his reason for holding the property, the relationship of the property to the taxpayer's trade or business, and the extent of its use must be examined ...." Ouderkirk v. Commissioner, T.C.M. at 530. At the time the taxpayer received the properties pursuant to the corporate liquidation, the sawmill business was obsolete and the taxpayer had no intention to operate the same business. As such, the taxpayer held the property "with a view to its eventual resale" hoping to get a good selling price for the land. Id. Although the taxpayer re-established the sawmill-lumber business, and removed some trees that were scattered on the 7,700 acres for processing through the sawmill, such conduct does not automatically cause the entire 7,700 acres to be treated as an asset used in the sawmill business within section 1231.[3] "The incidental use of this 7,700 acre

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[3] Section 1231 sets forth the rules for recognition of gains or losses resulting from sale or exchange of property used in a trade or business and involuntary conversions of such property. Section 1231(b)(1) defines the term "property used in the trade or business" as an asset that is subject to an allowance for depreciation under section 167. While the disputed property in Ouderkirk was adjudicated within the context of section 1231, the Tax Court's analysis therein is nevertheless applicable to our issue since Treas. Reg. § 1.954-2(e)(3)(ii) also defines tangible property as an asset that would be subject to a depreciation allowance under section 167. As such, both Treas. Reg. § 1.954-2(e)(3)(ii) and section 1231(b)(1) provide rules for depreciable property used in a trade or business.

tract in connection with such cutting of scattered timber did not convert the tract from investment property to real property used in the sawmill business ....” Id. Therefore, the tract of land at issue is not property used or held in the taxpayer’s trade or business.

Prior to FC2's disregarded entity election or liquidation, both FC1 and FC2 operated as separate corporations. FC2 was an operating company, while FC1 was a holding company. When FC2 liquidated, or elected to be treated as a disregarded entity, it effectively became a branch or division of its owner, FC1. *See* Treas. Reg. § 301.7701-2(a). As such, FC1 is then deemed to have the assets owned by FC2. While FC1 is deemed to have the assets owned by FC2, FC1 must nevertheless use, or hold for use, such assets for the requisite period of time in FC1's trade or business before FC1 is allowed to exclude from FPHCI the gain from the sale of those assets.

The trade or business in which FC2 used, or held for use, the subject assets cannot be attributed to FC1's holding period for said assets. This conclusion is supported by the language in Treas. Reg. § 1.954-2(a)(3) and other case law. Under Treas. Reg. § 1.954-2(a)(3), gain or loss derived from certain property transactions is included in the computation of FPHCI if the controlled foreign corporation holds that property for a particular use or purpose. Thus, the regulation requires that we look to the manner in which the controlled foreign corporation, FC1, used or held for use the subject asset, rather than the entity that previously held the property. Furthermore,

> [i]t is [also] a well settled principle [of law] that a shareholder has a separate identity from the corporation and that the business of a corporation is not the business of its shareholders or officers. Mere participation in a corporation by owning stock does not place one in the business of the corporation. Even devoting one’s time and energies to the affairs of a corporation is not of itself, without more, the trade or business of the person so engaged. Hamrick v. Commissioner, 38 T.C.M. at 308.

For a trade or business to exist, there must be some continuity and frequency of activity in a particular field. The elements of continuity and frequency of activity are lacking in both fact patterns since FC1 had no intention of continuing, or devoting its resources, to the future trade or business activities of its branch, FC2. The manner in which FC2 became a branch of FC1 constitutes an isolated and single transaction that was not undertaken for purposes of engaging or establishing a trade or business by FC1. Therefore, it would be difficult for FC1 to show that it was engaged in the trade or business of its branch during the time it held FC2's assets.

For the asset to be considered trade or business property, the asset must be devoted to a taxpayer's present or future business use. Simply because a taxpayer holds property as part of his business, such conduct does not automatically treat the property as a trade or business asset. Even in Ouderkirk, supra, where the taxpayer harvested the timber that was scattered throughout his land for approximately eight years, the Tax Court nevertheless concluded that the timberland was not a trade or business asset. The factors considered by the Tax Court in reaching its decision in Ouderkirk included (1) the taxpayer's intent for acquiring or holding the property, (2) the relationship of the property to the taxpayer's trade or business, and (3) the extent of its use.

In FC1's case, its intent for acquiring and holding the assets of FC2 was to sell those assets rather than employ such properties in FC1's trade or business. As such, the assets have no relationship to FC1's trade or business since FC1 is not continuing or engaging in present or future activities related to the particular field of endeavor. Even if FC1 uses the assets for one day, or for three months, such use is incidental to the reason FC1 is holding the assets, which is to sell those assets. Therefore, in both fact patterns, FC1 did not use, or hold for use, the assets of FC2 in the manner required by Treas. Reg. § 1.954-2(e)(3) and for the requisite holding period under Treas. Reg. 1.954-2(a)(3).

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