



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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Barbara A. Felker
Branch Chief, CC:INTL:Br3

SUBJECT:

This Field Service Advice responds to your memorandum dated March 2, 2000. Field Service Advice 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.

LEGEND

US1 =

US2 =

P =

Date 1 =

Country X =

FP1 =

FP2 =

Year 1 =

\$aa =

\$bb =
 \$cc =
 \$dd =
 \$ee =

ISSUES

(1) Whether the taxpayers are entitled to reduce their respective overall foreign loss (OFL) accounts by gain recognized on a disposition of operating intangibles to which both section 904(f)(3) and section 367(d) apply when the gain is treated as U.S. source income under section 367(d)?

(2) If the taxpayers are permitted to reduce their respective OFL accounts by the U.S. source income recognized on the disposition of the operating intangibles, does this U.S. source income reduce the OFL account in its entirety before any gain is required to be recognized on a transfer of tangible business property that would be recognized solely under section 904(f)(3)?

CONCLUSIONS

(1) Gain recognized on the disposition of the operating intangibles reduces the taxpayers' OFL accounts notwithstanding that the gain is treated as U.S. source income under section 367(d).

(2) U.S. source income that a taxpayer otherwise recognizes on a disposition of property subject to section 904(f)(3) reduces the applicable OFL account before gain that would be recognized solely under section 904(f)(3). Therefore, the U.S. source income recognized on the operating intangibles reduces the applicable OFL account before gain recognition would be triggered under section 904(f)(3) on the tangible business property. Because each taxpayer's proportionate share of the gain on the operating intangibles exceeds the taxpayer's applicable OFL account balance, the U.S. source income reduces each taxpayer's applicable OFL account balance in its entirety and no gain is recognized under section 904(f)(3) on the tangible business property.

FACTS

US1 is a domestic corporation that owned, through its domestic affiliates, a 50 percent interest in P, a domestic partnership. US2 is also a domestic corporation that owned, through its domestic affiliates, a 50 percent interest in P. P

operates a Country X joint venture. P's assets include operating intangibles and tangible business property.

On Date 1, the domestic affiliates of US1 and US2 contributed their respective interests in P to two newly-formed Country X unlimited liability companies, FP1 and FP2, which were treated as partnerships for U.S. tax purposes. Section 1491, as in effect for the year at issue, imposed an excise tax on the transfer of property by a domestic corporation to a foreign partnership. The excise tax could be avoided if a taxpayer made an election under section 1492 to apply principles similar to the principles of section 367 to the transfer. The domestic affiliates of US1 and US2 elected to apply principles similar to the principles of section 367 to the transfer of P to FP1 and FP2.

For purposes of section 367, the transfer of P to FP1 and FP2 is treated as if each partner transferred its pro rata share of the assets of P. See section 367(a)(4); Treas. Reg. §§1.367(a)-1T(c)(3)(ii) and 1.367(d)-1T(a). Accordingly, the domestic affiliates of US1 and US2 are treated as transferring their pro rata share of P's assets. Pursuant to regulations under section 367(d), the domestic affiliates elected to treat the transfer of the operating intangibles as a deemed sale. As a result of the deemed sale elections, the taxpayers were required to recognize U.S. source ordinary income in an amount equal to the excess of the property's fair market value over its adjusted basis. See Treas. Reg. §1.367(d)-1T(g)(2). US1 reported gain on the transfer of the operating intangibles under Treas. Reg. §1.367(d)-1T(g)(2). Taxpayers may transfer qualifying tangible business property without triggering gain recognition under section 367, and no gain was reported under section 367 with respect to the tangible business property.

At the time of the transfer, the US1 consolidated group and US2 consolidated group each had OFLs attributable to the general limitation category subject to recapture under section 904(f). For purposes of section 904(f)(3) and the regulations thereunder, the domestic affiliates of US1 and US2 are treated as transferring their proportionate shares of the assets of P. See Treas. Reg. §1.904(f)-2(d)(5)(ii). US1 reported recognized gain on the tangible business property under section 904(f)(3). US1 reduced its OFL account in the general limitation category by the total amount of the gain recognized on both the operating intangibles and the tangible business property.

The Examination Division has determined that the built-in gain on the operating intangibles is substantially greater than the amount of gain reported by the taxpayers. The proportionate share of the built-in gain on the operating intangibles attributable to each of US1 and US2 has been determined to be \$aa. Other amounts have been adjusted as well. The US1 consolidated group's proportionate share of the built-in gain on the tangible business property is \$bb and the US2 consolidated group's share of the built-in gain on the tangible business

property is \$cc. The US1 consolidated group's OFL account balance is \$dd and the US2 consolidated group's OFL account balance is \$ee. As a result of these adjustments, each group's share of the built-in gain on the operating intangibles and the tangible business property exceeds the group's OFL account balance. Accordingly, it is necessary to determine whether section 904(f)(3) applies to require gain recognition with respect to all or a portion of the tangible business property, or whether the OFL accounts are first reduced in their entirety by gain required to be recognized under both section 367(d) and section 904(f).

LAW AND ANALYSIS

(1) Pursuant to the deemed sale elections made by the domestic affiliates under the section 367(d) regulations, the US1 and US2 consolidated groups each recognized \$aa (each group's proportionate share of the excess of the property's fair market value over their adjusted basis) in gain as U.S. source ordinary income. You asked whether the taxpayers are entitled to reduce their respective OFL account balances under section 904(f) by the U.S. source income recognized pursuant to the section 367(d) regulations. For the reasons discussed below, the U.S. source income recognized on the deemed sale of the operating intangibles does reduce the applicable OFL account balance.

Section 904(f)(1) generally provides that if a taxpayer sustains an OFL, 50% of the taxpayer's foreign source taxable income in subsequent years will be treated as U.S. source income to the extent of the amount of the OFL. Section 904(f)(1) applies only to recharacterize foreign source taxable income that a taxpayer otherwise recognizes. It does not apply to U.S. source income.

Section 904(f)(3) generally provides that upon a disposition of property which has been used predominantly outside the United States in a trade or business, a taxpayer is deemed to have received and recognized foreign source taxable income in an amount equal to the lesser of the gain realized on the disposition or the taxpayer's remaining OFLs not recaptured under section 904(f)(1). The entire amount of such deemed foreign source income is then recharacterized as U.S. source income. See section 904(f)(3)(A)(ii). Section 904(f)(3) applies whether or not the taxpayer otherwise recognizes gain on the disposition. Section 904(f)(3)(B)(i). Section 904(f)(3) also applies without regard to the source of any gain that is otherwise recognized or the manner in which any gain is otherwise recognized. However, if foreign source gain is otherwise recognized, section 904(f)(3) applies only to the extent the foreign source gain is not already recharacterized under section 904(f)(1), which is limited to 50% of the taxpayer's total foreign source income unless the taxpayer elects to recapture a larger percentage. See sections 904(f)(1) and 904(f)(3)(A)(i).

The regulations implementing section 904(f) require a taxpayer who sustains an OFL in respect of a separate limitation category to establish an OFL account for that category. Treas. Reg. §1.904(f)-1(b). Additions are made to the OFL account to the extent an OFL in that category reduces U.S. source taxable income. Treas. Reg. §1.904(f)-1(d). The OFL account is reduced as the losses that resulted in the account are recaptured (*i.e.*, as foreign source taxable income in the same category as the losses is recharacterized as U.S. source income). Treas. Reg. §§1.904(f)-1(e) and 1.904(f)-2(a).

Treas. Reg. §1.904(f)-2(c) contains the rules relating to the recapture of losses under section 904(f)(1). Treas. Reg. §1.904(f)-2(c)(1) generally provides that the amount of any foreign source taxable income that must be recharacterized is the lesser of the balance in the applicable OFL account and (i) in a year in which the taxpayer elects the foreign tax credit, 50% of the taxpayer's foreign source taxable income of the same limitation as the loss that resulted in the OFL account or (ii) in a year in which the taxpayer deducts foreign taxes, foreign source taxable income of the same limitation as the loss that resulted in the OFL account minus foreign taxes imposed on such income. A taxpayer may elect to recapture more of the OFL account balance in any year in which the taxpayer elects the foreign tax credit. Treas. Reg. §1.904(f)-2(c)(2). Consistent with section 904(f)(1), Treas. Reg. §1.904(f)-2(c) applies only to recharacterize foreign source taxable income that a taxpayer recognizes irrespective of section 904(f). It does not apply to U.S. source income.

Treas. Reg. §1.904(f)-2(d) contains the recapture rules for dispositions of property subject to section 904(f)(3). Treas. Reg. §1.904(f)-2(d)(1) generally provides that if a taxpayer disposes of property used or held for use predominantly outside the United States in a trade or business and that property generates foreign source taxable income of the same limitation as the loss that resulted in the OFL account, gain will be recognized on the disposition and such gain will be treated as foreign source income subject to the same limitation as the income the property generated. The taxpayer's OFL account is recaptured by recharacterizing the foreign source taxable income that the taxpayer is deemed to recognize as U.S. source income. See Treas. Reg. §1.904(f)-2(d)(1). Consistent with section 904(f)(3), Treas. Reg. §1.904(f)-2(d)(1) applies without regard to whether any gain is otherwise recognized on the disposition, the source of any gain that is otherwise recognized on the disposition or the manner in which any gain is otherwise recognized.

The general recapture rules of section 904(f)(1) and Treas. Reg. §1.904(f)-2(c) do not apply to the U.S. source income recognized on the deemed sale of the operating intangibles because those rules only apply to foreign source taxable income. The transfer of the operating intangibles is, however, a disposition to which section 904(f)(3) and Treas. Reg. §1.904(f)-2(d) apply. Section 904(f)(3) and

Treas. Reg. §1.904(f)-2(d) apply to dispositions of property used in a foreign trade or business even though a taxpayer may recognize U.S. source income on the disposition under another provision of the Code and even though the gain may be recognized pursuant to a provision, such as section 367(d), that overrides an otherwise applicable nonrecognition provision.

The rationale for applying the disposition rules in this manner may be inferred from Treas. Reg. §1.904(f)-2(d)(1). As described above, for purposes of OFL recapture, Treas. Reg. §1.904(f)-2(d)(1) characterizes gain realized upon a disposition of property subject to section 904(f)(3) by reference to the type of income generated by the property. The regulation thus treats the gain realized on the disposition as a surrogate for the income that would have been generated by the property and recharacterized under the general recapture rules of section 904(f)(1) if the property had been retained. Because the gain is a substitute for the income generated by the property, the source of the gain is not relevant.

Therefore, under section 904(f)(3) and Treas. Reg. §1.904-2(d)(1), the U.S. source income recognized on the deemed sale of the operating intangibles is treated as foreign source taxable income in the general limitation category,¹ which is then subject to recharacterization as U.S. source income. The OFL account attributable to the general limitation category is reduced by the amount of the foreign source taxable income recharacterized as U.S. source income (see discussion (2) below). Treas. Reg. §§1.904(f)-1(e) and 1.904(f)-2(a).

It has been suggested that the gain on the deemed sale of the operating intangibles is section 904(f)(1) gain that would not reduce the previously deducted losses of a taxpayer's foreign branch for purposes of the branch loss recapture rules of section 367(a)(3)(C) and, thus, should similarly not reduce the taxpayer's OFL account for purposes of section 904(f). For the reasons discussed above, the gain on the operating intangibles is subject to section 904(f)(3), not section 904(f)(1). Moreover, we note that section 904(f)(1) income of a foreign branch (*i.e.*, foreign source taxable income of the foreign branch) would generally reduce the branch's previously deducted losses for purposes of section 367(a)(3)(C) because such income would generally constitute taxable income of the branch. See section 367(a)(3)(C)(ii)(I); Treas. Reg. §1.367(a)-6T(e)(2).

It has also been suggested that certain legislative history to section 367 indicates that where both section 904(f)(3) and section 367(d) apply to a disposition of intangibles, only section 367(d) should apply and the OFL account should not be reduced. The legislative history referred to states that upon the incorporation of a

¹ The operating intangibles generate active business income in the general limitation category because the intangibles are assets used in the taxpayer's trade or business.

loss branch with appreciated intangibles, it is intended that the transfer of the intangibles will generally be subject to the special rule for intangibles rather than the branch loss recapture rule. H.R. Conf. Rep. 98-861, at 956 (1984). We believe this language merely addresses the coordination of the branch loss recapture rules of section 367(a)(3)(C) with the intangible property rules of section 367(d). Accordingly, the legislative history does not provide authority for the proposition that section 904(f)(3) is inapplicable to a disposition which is also subject to section 367(d).

(2) The transfers of the operating intangibles and the tangible business property are dispositions of property to which section 904(f)(3) applies. Gain recognized on the dispositions reduces the OFL account attributable to the general limitation category. It was originally assumed that the OFL account balance attributable to the general limitation category exceeded the built-in gain on the operating intangibles and the tangible business property. Consequently, the issue of the order in which the disposition rules of section 904(f)(3) and Treas. Reg. §1.904(f)-2(d) apply to the built-in gains was not presented.

It has been determined that the balances in the taxpayers' respective OFL accounts attributable to the general limitation category are less than the taxpayers' respective shares of the built-in gain on the operating intangibles and the tangible business property. As a result, it is necessary to determine the order in which the built-in gains are subject to the disposition rules. For purposes of this discussion, we assume that the tangible business property qualifies for the exception contained in section 367(a)(3)(C) and, thus, is taxable solely under section 904(f)(3).

Treas. Reg. §1.904(f)-2(d) provides certain guidance regarding the order in which gain on a disposition of property subject to section 904(f)(3) recaptures the OFL account. Treas. Reg. §1.904(f)-2(d)(3) provides generally that if a taxpayer recognizes foreign source gain irrespective of section 904(f)(3) and there is a balance in the applicable OFL account after applying the general recapture rules, an additional portion of the OFL account will be recaptured in an amount equal to the lesser of (i) the remaining balance in the OFL account and (ii) the entire foreign source gain recognized on the disposition and not previously recharacterized under the general recapture rules. Treas. Reg. §1.904(f)-2(d)(4) provides generally that if gain on a disposition would not otherwise be recognized, the taxpayer must recognize and characterize as U.S. source income an amount of the gain equal to the lesser of (i) the balance in the taxpayer's applicable OFL account (after the account has been increased for amounts added to the account for the year and reduced by amounts recaptured under Treas. Reg. §§1.904(f)-2(c) and 1.904(f)-2(d)(3)) plus the amount of any OFL that would be part of a net operating loss if gain from the disposition were not recognized and (ii) the gain realized on the disposition. Treas. Reg. §1.904(f)-2(d) does not provide guidance on dispositions where U.S. source gain is recognized irrespective of section 904(f)(3).

The structure of the regulations suggests that the better view is that U.S. source gain that a taxpayer otherwise recognizes on a disposition of property that is subject to section 904(f)(3) should reduce the OFL account before gains that are recognized solely under section 904(f)(3). Treas. Reg. §1.904(f)-2(d) provides that foreign source gain that is recognized irrespective of section 904(f)(3) reduces the OFL account prior to gains that are recognized solely under section 904(f)(3). See Treas. Reg. §§1.904(f)-2(d)(4)(i)(A) and 1.904(f)-2(d)(6), Ex. (2). The regulation thus establishes a priority for gains that are recognized irrespective of section 904(f)(3) over gains that are recognized solely under section 904(f)(3). Although the regulation addresses only recognized foreign source gains, it is appropriate to give the same priority to recognized U.S. source gains given that section 904(f)(3) does not distinguish between U.S. and foreign source gains and that, as discussed above, the gain on the disposition is merely a substitute for the foreign source income that the property would otherwise generate.

Finally, foreign source gain a taxpayer recognizes on a disposition of property irrespective of section 904(f)(3) should recapture the applicable OFL account prior to U.S. source gain that a taxpayer recognizes irrespective of section 904(f)(3). The general recapture rules of section 904(f)(1) and Treas. Reg. §1.904(f)-2(c) apply prior to the disposition rules of section 904(f)(3) and Treas. Reg. §1.904(f)-2(d). See section 904(f)(3)(A)(i); Treas. Reg. §1.904-2(d)(3). Thus, foreign source gain that a taxpayer otherwise recognizes on a disposition of property is first recharacterized as U.S. source income under the general recapture rules up to the amount of the limits imposed therein. For any year in which the taxpayer elects the foreign tax credit, the taxpayer may elect to apply the general recapture rules without regard to the limits contained therein. Accordingly, in such cases, a taxpayer could elect to recharacterize the entire amount of the foreign source gain under the general recapture rules. See Treas. Reg. §1.904(f)-2(c)(2). Therefore, it is appropriate that the disposition rules apply to the foreign source gain remaining after application of the section 904(f)(1) recapture rules prior to U.S. source gain that a taxpayer otherwise recognizes on a disposition of property.

Because the U.S. source income recognized on the operating intangibles is recognized irrespective of section 904(f)(3) and the gain on the tangible business property would be recognized solely under section 904(f)(3), the gain on the operating intangibles recaptures the taxpayers' OFL accounts prior to the gain on the tangible business property. Consequently, each taxpayer's proportionate share of the U.S. source income (up to the amount of the taxpayer's balance in its OFL account attributable to the general limitation category) is treated as foreign source income in the general limitation category that is recharacterized as U.S. source income. Pursuant to Treas. Reg. §§1.904(f)-1(e) and 1.904(f)-2(a), the balances of the OFL accounts attributable to the general limitation category are reduced correspondingly. Because each taxpayer's share of the gain on the operating

intangibles exceeds its OFL account attributable to the general limitation category, each OFL account is reduced in its entirety and no gain is recognized under section 904(f)(3) on the tangible business property.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In your request for field service advice, you state that the no audit of P has been opened under the TEFRA partnership audit provisions. We previously suggested that you contact CC:DOM:FS:PROC regarding the applicability of the TEFRA audit provisions to the transaction. We understand that you submitted a request for field service advice on May 9, 2000, requesting advice as to the applicability of those provisions to the transaction, and we have not considered that issue as part of our advice.

Please call (202) 622-3850 if you have any further questions.

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