Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:INTL:Br3-PLR-101557-98
Date:
February 9, 1999

TY:

Corp X	=
FCo	=
Corp Y	=
Corp Z	=
State A	=
Business B	=
State C	=
Country D	=
E percent	=
Date F	=
Amount G	=
H percent	=
Date I	=
Amount J	=
Amount K	=
Amount L	=
Amount M	=

Dear

This ruling replies to a letter dated January 9, 1998, submitted on your behalf by your authorized representative, requesting rulings that (i) Corp X is eligible to make an election under section 865(h) of the Internal Revenue Code (Code) to treat gain realized from the sale of the stock of FCo as foreign source income, and (ii) any taxes imposed by Country D on the sale would be related to that foreign source gain for purposes of determining Corp X's allowable foreign tax credit. Additional information was submitted in letters dated June 3, 1998, June 9, 1998, December 22, 1998 and January 11, 1999. The information submitted for consideration is substantially as set forth below.

Corp X has requested this private letter ruling based on its return position that the gain from the sale of the stock of FCo is taxable in Country D pursuant to Article 21 of the income tax treaty between the United States and Country D (Treaty). Corp X is in the process, however, of preparing a claim for the business profits exemption under Article 7 of the Treaty on the basis that this gain constitutes business profits that are not attributable to a permanent establishment. If Country D determines that the gain from the sale of the stock of FCo is exempt from Country D tax under Article 7 of the Treaty, section 865(h) would not apply because the gain would not be treated as from sources within Country D under the Treaty. If Country D makes such a determination, Corp X represents that it shall notify the Secretary as required by section 905(c) and the regulations thereunder.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

Corp X, a State A corporation, is engaged in Business B, both directly and indirectly through subsidiaries. Corp X is a publicly traded corporation with worldwide operations. Corp X owns 100 percent of the stock of Corp Y, a State A corporation. Corp Y owns 100 percent of the stock of Corp Z, a State C corporation. Corp X, Corp Y, and Corp Z are all members of an affiliated group of corporations that files consolidated federal income tax returns. Corp X is the common parent of the affiliated group. Corp Y and Corp Z are both United States residents within the meaning of section 865(g)(1)(A) of the Code.

Prior to the sale transaction described below, Corp Z owned E percent of the single class of stock of FCo, a Country D corporation. The remainder of the stock of FCo was owned by unrelated foreign persons. FCo was not a controlled foreign corporation within the meaning of section 957(a) of the Code on the date of the transaction or at any time during the 5-year period ending on that date.

On Date F, Corp Y contracted to sell all the shares of FCo owned by the affiliated group to an unrelated purchaser. The consideration agreed upon was Amount G, plus a call option to receive approximately H percent of the outstanding stock of a foreign corporation owned by the unrelated purchaser. This sale transaction was completed on Date I.

Immediately prior to the sale, Corp Z transferred to Corp Y all of its shares of FCo for a total consideration of Amount J, an amount significantly less than the fair market value of the FCo shares. This transfer, which allowed Corp Y to be the transferor of the FCo shares for purposes of the sale to the unrelated purchaser, took place for two reasons. First, the Corp X affiliated group wished to have Corp Y, a significant holding company within the group, receive the call option from the unrelated purchaser. Second, the Corp X group believed that the transfer of the shares from Corp Z to Corp Y provided a basis for arguing, for Country D purposes, that the gain from the sale of those shares to the unrelated purchaser should be exempt from Country D tax pursuant to Article 7 of the Treaty.

The transfer of the FCo shares from Corp Z to Corp Y triggered taxable gain of Amount K under section 1001 of the Code. In addition, the transfer of these shares for less than their fair market value constituted a deemed distribution of appreciated property to Corp Y, thereby triggering further gain of Amount L under section 311(b) of the Code. Amount L represents the difference between the fair market value of the shares and the consideration received by Corp Z for those shares (Amount J). Corp Y took the shares of FCo at a basis of Amount J plus Amount L and sold the shares to the unrelated purchaser for the same amount. Because Corp Y incurred transaction costs associated with the sale, Corp Y realized a loss on the sale not exceeding Amount M.

Corp X represents that, for U.S. purposes, the transfer of the FCo shares from Corp Z to Corp Y is an intercompany transaction within the meaning of Treas. Reg. § 1.1502-13(b)(1)(i)(A). Corp X further represents that Corp Z's gain thereon is an "intercompany item" within the meaning of Treas. Reg. § 1.1502-13(b)(2), and Corp Y's loss upon the sale to the unrelated purchaser is a "corresponding item" within the meaning of Treas. Reg. § 1.1502-13(b)(3)(i). Corp X represents that, as an intercompany item, Corp Z's gain was deferred and taken into account pursuant to Treas. Reg. §1.1502-13(c)(2)(ii) upon the sale of FCo by Corp Y to the unrelated purchaser.

For Country D purposes, the transfer of the FCo shares from Corp Z to Corp Y is not taxed because Corp Y and Corp Z elected to apply a Country D rollover provision that protects such related-party transfers from tax. Absent the election, this transfer would have required Corp Z to recognize the full appreciation in the FCo shares under the laws of Country D. Pursuant to the election, Corp Y takes a carryover basis in the FCo stock from Corp Z. Under the laws of Country D, Corp Y then realized all the gain upon its sale of the FCo stock to the unrelated purchaser. This gain is fully subject to tax in Country D unless it is exempt from taxation under Article 7 of the Treaty. If, for any reason, Country D determines that the rollover provision does not apply to the transfer of the FCo shares from Corp Z to Corp Y, Corp Z will be required to recognize the gain thereon.

Section 865 of the Code generally provides that income from the sale of personal property by a United States resident shall be sourced in the United States. Section 865(h) provides that a taxpayer may elect to treat the gain from the sale of stock of a foreign corporation as foreign source gain if the gain would (apart from the application of section 865(h)) be sourced in the United States under section 865, but would be sourced outside the United States under a treaty obligation of the United States. If a taxpayer makes this election, the foreign tax credit provisions of section 904(a), (b), and (c), and sections 902, 907, and 960 are applied separately with respect to such gain. Thus, for purposes of computing the foreign tax credit limitation under section 904, this gain is placed in its own separate limitation category.

Treas. Reg. § 1.904-6(a)(1)(i) provides that the amount of foreign taxes paid or accrued with respect to a separate category of income shall include only those taxes that are related to income in that separate category. Taxes are related to income if the income is included in the base upon which the tax is imposed.

Treas. Reg. § 1.1502-77(a) generally provides that the common parent of an affiliated group of corporations filing consolidated returns shall, for all purposes (with exceptions not relevant here), be the sole agent for each subsidiary of the group, duly authorized to act in its own name in all matters relating to the tax liability for the consolidated return year. Under Treas. Reg. § 1.1502-77(a), a common parent of an affiliated group of corporations filing consolidated returns must make the election to apply section 865(h) on behalf of its subsidiary.

Article 7(1) of the Treaty generally provides that the business profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.

Article 21(1) of the Treaty provides that items of income of a resident of a Contracting State not expressly mentioned in Articles 1 though 20 of the Treaty are taxable only in that State. However, Article 21(2) provides that if the income is derived by a resident of one of the Contracting States from sources in the other Contracting State, the income may also be taxed in the State in which it has its source.

Article 27(1)(a) of the Treaty provides that income derived by a resident of the United States which, under the Treaty, may be taxed by Country D shall, for the purposes of the income tax law of Country D and of the Treaty, be deemed to be income from sources within Country D.

To determine the source of an item of income for purposes of Article 21(2), it is necessary to look to the internal law of the State whose income is being determined. See the Technical Explanation to Article 21. Under Country D law, a nonresident of Country D is subject to the Country D capital gains tax upon the disposition of an asset that is considered to have a sufficient nexus to Country D. Among the assets considered sufficiently connected to Country D is stock of a Country D corporation. Thus, Country D's taxation of the gain derived from the sale of the FCo stock constitutes sourced-based taxation. As a result, the gain would be taxable by Country D as income from sources within Country D under Article 21(2) of the Treaty. Accordingly, the income would be sourced within Country D for purposes of the Treaty pursuant to Article 27(1)(a).

If Country D determines that Corp Y's gain from the sale of the FCo stock is exempt from tax under Article 7 of the Treaty, Article 21 will not apply. If, however, Corp X's claim is denied by Country D and, as a result, Article 21 of the Treaty applies to the gain from the sale of the FCo stock, it is held that Corp X is entitled to make an election under section 865(h) to treat Corp Z's gain realized from the sale of the stock of FCo as foreign source income because the gain would be considered U.S. source income under section 865(a), but would be foreign source income under a treaty obligation of the United States. In addition, because the gain from the sale of the stock of FCo is included in the base upon which Country D taxes are imposed, it is further held that the Country D tax imposed on that gain is related to the gain derived by Corp Z, and is therefore allocable to the separate section 865(h) income category for purposes of computing the foreign tax credit limitation.

No ruling has been requested and no opinion is being offered as to whether the gain from the sale of the stock of FCo constitutes business profits within the meaning of Article 7 of the Treaty. In addition, no ruling has been requested and no opinion is being offered as to the application of Treas. Reg. § 1.1502-13(c) with respect to the transactions described in this letter.

A copy of this letter must be attached to Corp X's U.S. income tax return for the year in which Corp X obtained the ruling.

This ruling is directed only to the taxpayer requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Irwin Halpern
Senior Technical Reviewer, Branch 3
Office of Associate Chief Counsel
(International)

cc: