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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated October 1, 1998. 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

Selling Consolidated Group (S) =

Purchaser (P) =
Target (T) =

Target Affiliate (TA1) =

Target Affiliate 2 (TA2) =

Target Affiliate 3 (TA3) =

Target Affiliate 4 (TA4) =

Target Affiliate 5 (TA5)	=
Target Affiliate 6 (TA6)	=
Purchaser's Common Parent (PCP)	=
Target Affiliate 7 (TA7)	=
Corporation C (C)	=
Purchaser's Parent (PP)	=
PPP	=
Corp I	=
Corp J	=
Business A International Group 1	=
Business A International Group 2	=
Business A	=
Acquisition Date	=
Date 2	=
Date 3	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=

Q	=
N	=
$D	=
$F	=
$G	=
$H	=
$J	=
$K	=
$L	=
$M	=
$N	=
$O	=
$U	=
$V	=
$W	=
$X	=
$Y	=
$Z	=
$AA	=
$BB	=
$CC	=
Country V	=
Country P	=
Country Q	=
Country R	=
Closing Agreement	=

Document 1 =

ISSUES

1. May all or a portion of the foreign tax credits relating to Country V taxes paid by T on the sale (for Country V purposes) of the TA1 assets in Year 4 be denied to T (and the PCP consolidated group) and allocated to S, based on the principles of Rev. Rul. 75-532?

2. If PCP calculated its purchase price paid for the worldwide Business A assets in Year 2 included an amount equal to the Country V tax paid by T in Year 4 on the sale of the TA1 stock, and if PCP improperly claimed (and the Closing Agreement improperly allowed) basis for those contingent future liabilities, under §1.338(b)-2T, may we reduce the amount of the basis allocated under §1.338(b)-2T or disallow the foreign tax credit to T (and the PCP consolidated group) for the Country V taxes paid by T in Year 4 on the actual sale of the assets of TA1?

CONCLUSIONS

1. Neither all nor a portion of the foreign tax credits relating to Country V taxes paid by T on the sale of the TA1 assets (for Country V purposes) in Year 4 may be denied to T (and the PCP consolidated group) and allocated to S, based on the principles of Rev. Rul. 75-532.

2. It does not appear that PCP calculated its purchase price paid for the worldwide Business A assets in Year 2 by including an amount equal to the Country V tax paid by T in Year 4 on the sale of the TA1 stock, or that if PCP improperly claimed (and the Closing Agreement improperly allowed) basis for those contingent future liabilities. However, should further factual development reveal that this is not the case, the Service should consider legal arguments justifying a reduction in the amount of the basis allocated under §1.338(b)-2T or a disallowance of the foreign tax credit to T (and the PCP consolidated group) for the Country V taxes paid by T in Year 4 on the actual sale of the assets of TA1.

FACTS

S is a U.S. consolidated group engaged in Business A worldwide. T and TA4 are U.S. corporations that, prior to the Year 2 Acquisition Date, were owned directly by S. TA5, TA6 and T7 are Country P, Country Q and Country V corporations, respectively, owned directly by S prior to the Acquisition Date in Year 2. At that time, T directly owned 100 percent of the stock of TA2 and TA3, Country V corporations for U.S. income tax purposes. T directly owned 99.98% of the stock of TA1, also a corporation for U.S. income tax purposes. TA2 directly owned the remaining .02% of the TA1 stock. For Country V purposes, TA1 is a partnership and TA2 and TA3 are separate corporate entities.

PCP is the owner of the purchasing group, and is the domestic common parent of a U.S. consolidated group. PP is a Country V corporation indirectly owned Q percent by I and P percent by J. I and J are wholly owned by PCP and are members of the PCP consolidated group. PP owned 100 percent of the stock of P, a Country V corporation, until the liquidation of P in Year 4.

The Business A International Group 1, consisting of T, TA1-TA4, TA6 and TA7, was acquired by S in Year 1 for $V. In Year 2, S and PCP began negotiating for the sale by S to P of the Business A International Group 1, and the Business A International Group 2, including TA5.[1]

On the Year 2 Acquisition Date, as part of the worldwide acquisition of Business A, P acquired the stock of T for cash of $Z (denominated in Country V currency), plus $CC liabilities assumed by P, allocated largely to the stock of TA1. S and PCP jointly made an election for T under section 338(h)(10)[2] that, in turn, triggered deemed elections under section 338(g) for TA1, TA2 and TA3. S offset the taxable income resulting from the sale with NOLs.

Later in Year 2, T was recapitalized, the tax-free nature of which has not been challenged by the Service. In the recapitalization, T offered three classes of stock, two common and one preferred. PPP, a domestic member of the PCP consolidated group, received all of the shares of a new class of T voting preferred

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[1] Originally, the sale of Business A was structured as an asset sale for cash in the amount of $W (denominated in Country V currency). Because of the insistence by S that the sales of T, TA4 and TA5 be stock sales, the purchase price was reduced to $X (cash) to take into account the fact that the PCP group would be responsible for payment of the Country V tax when the acquired companies with Country V assets finally sold them. The purchase price of Business A was further reduced to $Y (cash) as a result of the findings from PCP's due diligence study.

[2] An election under section 338(h)(10) may only be made for a domestic target that does (or could) be included in the seller's consolidated group. The election must be signed by both the buyer and the seller. The domestic target for which the election is made is deemed to have sold all of its assets to a fictitious New Target on the acquisition date and liquidated into the selling consolidated group under section 332. The domestic target will file as a member of the seller's consolidated group with respect to its short taxable year ending on the acquisition date. The seller will not be deemed to have sold the stock of the domestic target.

A section 338(g) election differs in that it can be made for any domestic or foreign target. Both the sale of the target's stock and the deemed sale of the target's assets are recognized. The target may not, even if otherwise eligible, file as part of the seller's consolidated group with respect to the one day period of acquisition date. Instead, the target files a one-day separate tax return for that day. Section 1.338-1(e)(2). If the target is the common parent of a consolidated group, the group files a short year consolidated return including the acquisition date. Section 1.338-1(e)(1). If the target is foreign or a domestic corporation not a part of a consolidated return, a short year separate tax return is filed for the period including the acquisition date.

stock (one-third of the number of shares issued), P's shares in T were reclassified as T non-voting common stock (one-third of the number of shares issued), and all of the shares of a class of T voting common stock (one-third of the number of shares issued) were issued to C, a Country R corporation that is wholly owned directly by PCP.

On Date 2 in Year 4, T sold the stock of TA1[3] and TA2 to PP, for a total of $BB, an increase for U.S. income tax purposes over the amount PCP allocated to the assets of TA1 and TA2 when purchased from S. The increase in the amount paid for U.S. tax purposes was apparently due to Country V currency exchange fluctuations of $M, on which T paid U.S. tax in Year 4.[4] For Country V purposes, T's sale of stock was characterized as a sale by T of TA1's assets. T paid a Country V tax of $U on the asset sale.

The purchase of the TA1 assets by P from T was treated for U.S. tax purposes as a redemption of P's interest in T, as the effective value of the T stock was reduced. Subsequent to the sale by T of TA1 and TA2 to P in Year 4, PCP subscribed to one share of T non-voting common stock and issued a promissory note in the amount of $D to T, which was recorded as additional paid in capital. Later in Year 4, PCP paid $F to T, a portion of the promissory note equal to the foreign taxes paid by T to Country V (prior to reduction to $U on audit). T was not a member of the PCP consolidated group in Year 4, and claimed a foreign tax credit under section 901, as limited by section 904, with respect to approximately half of the tax paid by T to Country V on its separate return. By the middle of Year 5, T had merged into PCP under section 368(a)(1)(A) [5] and the remainder of the tax paid to Country V in Year 4 was credited against the U.S. tax liability of PCP in Years 6 and 7.[6] Sometime subsequent to its purchase of the stock of TA1, P liquidated into PP.

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[3] Paragraph (5) of the Closing Agreement between PCP and the IRS states that the Country V tax is subject to the high-tax kick out of section 904(d) into the general limitation basket. Paragraph (6) of the Closing Agreement states that the sale of the stock of TA1 occurred outside the U.S. under section 865.

[4] Both in the Year 2 indirect sale by S of TA1 - TA3 to P and in the Year 4 sale of TA1and TA2 by T to P, the purchase price was denominated in Country V currency. The sales price for TA1 and TA2 in both sales remained nearly the same when denominated in the Country V currency. However, in Year 4 the Country V currency was stronger against the dollar than in Year 2. Therefore, for U.S. purposes, there was gain of $M on the sale of TA1 and TA2 due to a fluctuation in the exchange rate of Country V currency on the Year 4 sale. See Document 1.

[5] In Year 5, PPP distributed all of its T stock to PCP as a dividend. The T Board of Directors substantially reduced the par value of the T stock owned by P, T purchased and canceled at par the T shares held by C and PP (acquired from P upon its liquidation), and T liquidated into PCP.

[6] Under the SRLY rules of section 1.1502-4(f)(2) and section 381(c)(23), PCP stepped into the shoes of T with respect to the SRLY limitation. Therefore, the foreign taxes carried forward could be used by PCP in their entirety, but not by other members of the PCP consolidated group.

On Date 3 of Year 8, PCP and the Service agreed in the Closing Agreement that:

1. Between the Acquisition Date and Date 2 of Year 4, the fair market value of TA1 and TA2 increased by approximately $G, to $H.

2. On Date 2 of Year 4, T's basis in TA1 and TA2 was $J ($AA in TA1 and $O in TA2).[7]

3. T realized $K of Country V source gain on the sale of TA1 and TA2. T is then considered to have contributed $K to the capital of P, and T's basis in P was increased by that amount.

4. T paid a tax of $U to Country V on the sale of TA1 and TA2 to P.

5. T's Year 4 U.S. taxable income was adjusted upward by $L ($K - $M, gain already reported from exchange rate differences between Year 2 and Year 4) as a result of the sale of the assets of TA1 and the stock of TA2.

Years 2 (both through the Acquisition Date and post-acquisition) and 4 are still open with respect to S. Years 2 (through the Acquisition Date) and 4 are still open with respect to PCP and T, but subject to the Closing Agreement. T filed a separate return for its short post-acquisition taxable year in Year 2. That year is closed.

LAW AND ANALYSIS

ISSUE 1

In general, domestic corporate taxpayers such as T may claim a credit for foreign income taxes in the U.S. taxable year in which the foreign taxes accrue. Section 901(b)(1); § 1.905-1(a). Section 1.461-4(g)(6)(iii)(B) provides that creditable foreign taxes accrue when the all events test is met, regardless of when the tax is paid. When the U.S. and foreign taxable years do not coincide, Rev. Rul. 61-93, 1961-1 C.B. 390, holds that the foreign taxes accrue in the U.S. taxable year within which the foreign taxable year ends, even though a portion of the foreign tax may be imposed on income that is taxed by the U.S. in the preceding U.S. taxable year. However, in limited instances, discussed and distinguished below, taxes may be allocated from the short tax year of New Target,

[7] This increase in basis from $Z to $J was due to the use of an incorrect currency exchange rate Country V currency to dollars in Year 2 on the sale of T to P by S. The Country V currency was apparently stronger against the dollar in Year 2 than was originally reported. No U.S. tax was paid on this corrected Year 2 gain. See footnote 9.

following an election under section 338, to the short tax year of Old Target preceding that election.

When a foreign taxable year overlaps two short U.S. taxable years created by section 338 and ends within New Target's short U.S. taxable year beginning the day after the acquisition date, the application of the accounting principles discussed above would allocate all of the foreign taxes to the short U.S. tax year of New Target and its consolidated group, if any, as all events necessary to establish Target's (Old and New) foreign tax liability cannot occur until the end of the foreign tax year. Accordingly, under these rules, the purchasing group would be entitled to the use of all of the foreign taxes paid by Target for the full 12-month foreign tax year, even though Target's U.S. taxable income for the year is divided between two short U.S. tax years. In recognition of the asymmetries created by the attribution of 12 months of foreign taxes to a U.S. tax year of less than 12 months, Rev. Rul. 75-532, 1975-2 C.B. 295, referring to the principles of § 1.1502-76(b)(4) (now § 1.1502-76(b)(3)), allows the allocation of foreign income taxes of a domestic target corporation between the buyer's consolidated group and the target corporation's separate return for the short period ending on the acquisition date.[8]

The principles of Rev. Rul. 75-532 could have applied to allocate a portion of T's foreign tax to its short Year 2 tax year preceding the section 338 election (and, thus, to S's consolidated return year including that short tax year) if New Target (T) had sold the stock of TA1 in the short Year 2 tax year following the Acquisition Date. However, the foreign taxes at issue here accrued in Year 4, a full 12-month U.S. tax year, not in the short Year 2 tax year. Accordingly, the principles of Rev. Rul. 75-532 do not apply to support allocation of a portion of T's Year 4 taxes to S.

ISSUE 2

Subject to certain limitations, section 901 permits a domestic corporation to claim as a credit against its federal income tax any income taxes paid to a foreign country. Sec. 1.901-1. The purpose of the credit is to reduce international double taxation. American Chicle Co. v. United States, 316 U.S. 450, 452 (1942). Although U.S. tax principles govern for purposes of determining whether a foreign levy is a creditable income tax, the law of the foreign state is looked to in determining the nature of the rights and obligations that form the basis of the claim of a foreign tax credit. See Biddle v. Commissioner, 302 U.S. 573 (1938); Phillips

[8] Subsequently, with respect to taxable years not involved here, § 1.338-5(d) extended this principle to short U.S. tax years of domestic and foreign target corporations in acquisitions covered by an election under section 338.

Petroleum Co. v. Commissioner, 104 T.C. 256, 295 (1995). A domestic corporation may be entitled to claim a credit under section 901 for creditable foreign income taxes paid if it is legally liable under foreign law for the tax. Section 1.901-2(f). Here, the facts indicate that T was a domestic corporation that was legally liable for Country V income tax paid on its Year 4 sales of the assets of TA1 to P.

Basis is properly assigned only to accrued but unpaid liabilities assumed at sale, not for contingent, unaccrued liabilities. Based on the information submitted, it appears that, under §1.338(b)-2T, the taxpayer allocated the proper dollar amount, $Z, to the basis of the T stock, and to the assets held by T, including the stock of TA1 - TA3 and their assets, out of a cash amount paid for the worldwide Business A assets sold by S. Moreover, it appears that no liabilities, either contingent or properly accrued, were included in the $Z paid for the stock of T in Year 2.[9] Further factual development may be appropriate to confirm these preliminary conclusions. If further factual development reveals that these preliminary conclusions are inaccurate, the Service should consider legal arguments justifying a reduction in the amount of the basis allocated under §1.338(b)-2T or a disallowance of the foreign tax credit to T (and the PCP consolidated group) for the Country V taxes paid by T in Year 4 on the actual sale of the assets of TA1.

[redacted]

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[9] The summary of adjustments included in Document 1 indicated that in Year 4 the Service adjusted the basis of the TA1 assets upwards by $N. This increase relates to basis given because of a (untaxed) Year 2 gain on the sale of T due to the fluctuation of the Country V currency vis a vis the dollar. See footnote 7.

[redacted]

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