IRS applies Section 904(f) recapture exception to intercompany asset transfer preceding deconsolidation of transferee member

Executive summary

In Private Letter Ruling 201452002 (issued 18 September 2014), the IRS concluded that Treas. Reg. Section 1.1502-9(b)(vi), which generally eliminates any Section 904(f) recapture for a disposition that qualifies as an intercompany transaction under Treas. Reg. Section 1.1502-13, applied to an intercompany transfer of assets, even though the intercompany transfer was part of a pre-arranged plan in which the transferee left the US consolidated group.

Discussion

Background — general principles

A taxpayer has a separate limitation loss (SLL) with respect to a Section 904(d) separate limitation category when deductions properly allocated to the separate limitation basket exceed gross income in that basket. If an SLL in one separate limitation basket offsets income in another separate limitation basket, the amount of the offset is added to the taxpayer’s SLL account, and the balance of the SLL account is subject to recapture (recharacterization of future foreign separate limitation income in the separate limitation basket that has the SLL account as income in the separate limitation basket whose income was offset).1
A taxpayer has an overall foreign loss (OFL) for the tax year when its aggregate foreign losses exceed its aggregate foreign income. If an OFL offsets domestic income in a given year, the amount of the offset is added to the taxpayer’s OFL account, and the balance of the OFL account reflects the amount subject to recapture (i.e., recharacterization as domestic-source income in future tax years).

An OFL is computed separately for each of the Section 904(d) separate limitation categories.

Under Section 904(f)(3) and the corresponding Treasury regulations, if a taxpayer disposes of property used or held for use predominantly without the United States in a trade or business and that property generates foreign-source taxable income subject to a separate limitation in which the taxpayer has an OFL account balance (including a balance arising in the year of the disposition) (such property referred to as “Section 904(f)(3) property”), certain gain recognition and recapture rules apply, notwithstanding that a non-recognition rule would otherwise apply to the transaction.

Section 904(f)(3)D treats stock in a controlled foreign corporation (CFC) as Section 904(f)(3) property in certain instances. Dispositions for purposes of Section 904(f)(3) include sales, exchanges, distributions, contribution to a corporation or any other transfer of property. Under Section 904(f)(5), if a taxpayer has an SLL account, rules similar to the rules of Section 904(f)(3) apply to any disposition of property if gain from such disposition would be in the income category for which there was such SLL.

**Consolidated Group OFLs and SLLs**

For a US consolidated group, the foreign tax credit for the consolidated return year is determined on a consolidated basis under the principles of Sections 901 through 905 and Section 960. Under Treasury regulations, consolidated overall foreign loss (COFL) accounts, consolidated separate limitation loss (CSLL) accounts and consolidated overall domestic loss (CODL) accounts are determined by the consolidated group on an aggregate basis. When a new member joins the group, its separate OFL, SLL and ODL accounts are combined with the appropriate COFL, CSLL and CODL accounts of the group.

Under Treas. Reg. Section 1.1502-9(c), when a member leaves the consolidated group, it is allocated a pro rata portion of each of the group’s COFL, CSLL and CODL accounts based on the member’s share of the group’s assets that generate income subject to recharacterization under the corresponding loss account. The group’s COFL, CSLL, and CODL accounts are correspondingly reduced.

Treas. Reg. Section 1.1502-9(b)(6)(i) provides that neither Section 904(f)(3) (for a COFL account) nor Section 904(f)(5)(F) (for a CSLL account) applies at the time of a disposition that is an intercompany transaction to which Treas. Reg. Section 1.1502-13 applies. Instead, Section 904(f)(3) and Section 904(f)(5)(F) apply only at that time and to the extent that the group is required under Treas. Reg. Section 1.1502-13 (without regard to Section 904(f)(3) and Section 904(f)(5)(F)) to take into account any intercompany items resulting from the disposition, based on the COFL or CSLL account existing at the end of the consolidated return year during which the group takes the intercompany items into account.

In general, an intercompany transaction is defined in Treas. Reg. Section 1.1502-13 as “a transaction between corporations that are members of the same consolidated group immediately after the transaction.” Intercompany transactions include the sale of property or other transfer, such as an exchange or contribution, from one member of the consolidated group to another member.

**Simplified facts of PLR**

FP, a foreign corporation, indirectly owned US Parent, the parent of a US consolidated group (members of US Parent’s consolidated group, collectively and/or individually referred to as US Group). Additionally, FP indirectly owned FP Sub2, a foreign corporation for US tax purposes. FP Sub2 owned a number of foreign entities that were not CFCs for US tax purposes (the FP Foreign Entities).
US Parent indirectly owned an interest in US Sub1, a US entity that was a corporation for US tax purposes. US Sub1 owned an interest in US DRE1, which was a disregarded entity for US tax purposes. US Sub1 owned an interest in US Sub2, a US entity that was treated as a corporation for US tax purposes. Prior to the Transaction (defined below), US Sub1 and US Sub2 were affiliates of US Group.

Additionally, US DRE1 owned an interest in a foreign disregarded entity (FDRE2) that, in turn, indirectly owned CFC FSub3, which was a controlled foreign corporation for US tax purposes. CFC FSub3 owned a number of foreign entities (US Group Foreign Entities). The majority of the US Group Foreign Entities were disregarded for US tax purposes. The remaining entities were CFCs for US tax purposes.

Under a pre-arranged plan, the following transactions were undertaken:

- US Sub1 formed US Holdco, a US entity that was treated as a corporation for US tax purposes.
- In a transaction represented to qualify as a Section 351 contribution, US Sub1 contributed its interest in US DRE1, along with certain additional property, to US Holdco (Contribution 1). US Holdco was a US entity that was treated as a corporation for US tax purposes.

Because US DRE1 owned FDRE2, which, in turn, owned CFC FSub3, Contribution 1 included a transfer of stock in a CFC, potentially Section 904(f)(3) property. Although not explicitly stated in the ruling, it is possible that FDRE2 also held other Section 904(f)(3) property.

- Subsequent to Contribution 1, FP Sub 2 contributed the FP Foreign Entities to US Holdco (Contribution 2) for stock in US Holdco.

Following Contribution 2, US Holdco ceased to be a member of US Group's US consolidated group and became the parent of a separate US consolidated group.

Prior to the Transaction, US Group had a COFL account, a CSLL account and an ODL account. The ruling states that all income, loss, tax attributes, and COFL and CSLL accounts currently were, and were expected to continue to be, in the Section 904(d) general category, except for a small ODL in the passive category.

PLR conclusions

Without any elaboration or analysis, the PLR concluded the following:

- US Holdco is considered a member of the US Group for the period between the formation of US Holdco and Contribution 2.
- Since US Holdco is considered a member of the US Group for the period between the formation of US Holdco and Contribution 2, Contribution 1 is an intercompany transaction within the meaning of Treas. Reg. Section 1.1502-13(b).

- Since Contribution 1 is an intercompany transaction within the meaning of Treas. Reg. Section 1.1502-13(b), except to the extent required by Treas. Reg. Section 1.1502-9(b)(6)(i), no recapture will arise under Section 904(f)(3) or Section 904(f)(5)(F) at the time of either Contribution 1 or Contribution 2 to reduce the US Group's COFL and CSLL accounts that are apportioned at the time of Contribution 2 among the US Group, US Holdco and US Sub2 under Treas. Reg. Section 1.1502-9(c)(2).

Implications

Contribution 1, viewed in isolation, was an intercompany transaction that would not have been expected to give rise to OFL or SLL gain recognition and recapture under the exception in Treas. Reg. Section 1.1502-9(b)(6)(i) for intercompany transactions. Because Contribution 1 was part of an overall transaction in which US Holdco, the acquiror of the Section 904(f)(3) property, exited the transferor's US consolidated group, however, there may have been some question whether the Treas. Reg. Section 1.1502-9(b)(6)(i) exception applied to Contribution 1. Nonetheless, PLR 201452002
concluded that the Treas. Reg. Section 1.1502-9(b)(6)(i) exception applied to a transfer of Section 904(f)(3) property from one consolidated group member to another member, even though the transferee exited the consolidated group in a later step of the same overall transaction (taking its pro rata portion of the accounts under Treas. Reg. Section 1.1502-9(c)).

The conclusion in PLR 201452002 is consistent with PLR 201047016 (26 November 2010), in which the IRS concluded that a contribution of property to a controlled corporation that was subsequently transferred out of the group in a Section 355 distribution was to be treated as “an intercompany transaction within the meaning of Treas. Reg. Section 1.1502-13(b)(1), including for purposes of Temp. Treas. Reg. Section 1.1502-9T.”

Endnotes
1. 1 See generally Treas. Reg. Section 1.904(f)-7.
2. See generally Treas. Reg. Section 1.904(f)-1.
3. The term “disposition” includes a sale, exchange, distribution, or gift of property whether or not gain or loss is recognized on the transfer, but does not include a disposition of property to a domestic corporation in a distribution or transfer described in Section 381(a). (Section 904(f)(3)(B)(i) and Section 904(f)(3)(C)(ii)).
5. See Treas. Reg. Section 1.1502-4(c).
10. Id.
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EYG No. CM5100

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