OFFICE OF
CHIEF COUNSEL

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

Number: **200046008**
Release Date: 11/17/2000
CC:INTL:Br.4: August 4, 2000
WTA-N-107927-00
UILC: 954.02-05

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Scott Hargis
District Counsel, Laguna Niguel
CC:WR:SCA:LN

FROM: Phyllis Marcus
Chief CC:INTL: BR2

SUBJECT:

This Field Service Advice addresses an issue that has arisen in the examination of the above taxpayer. 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.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of

this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

W =
X =
Y =

FNewco 2 =
FC1 =
FC2 =
FC3 =
FC4 =
FC5 =
FC6 =
State =
Date =
Country A =
Country B =
Country C =
Business A =
Business B =

ISSUE

Whether gains from the sales of assets by FC2 and FC3, controlled foreign corporations (CFCs), in the circumstances described herein, are foreign personal holding company income (FPHCI) under section 954(c)(1)(B) of the Code.

CONCLUSION

Gains from the sales of assets by FC2 and FC3 are FPHCI under section 954(c)(1)(B). The asset sales are not excepted from FPHCI under section 1.954-2(e)(3)(ii)-(iv).

FACTS

W is a U.S. holding corporation formed under the laws of State. Prior to Date, W owned all of the stock of X and of Y, each of which is also a U.S. corporation formed under the laws of State. Y is engaged in Business A. X is engaged in

Business B and owns all of the stock of FC1, a corporation formed under the laws of Country A. FC1 owns all of the stock of FC2 and FC3, formed under the laws of Country A and Country B, respectively. Prior to Date, FC2 owned all of the stock of FC4, a corporation formed under the laws of Country A. FC3 owned all of the stock of FC5, a corporation formed under the laws of Country B. FC2 was a holding company and FC3 engaged in Business B. At all times, FC4 has been engaged in Business A. On or about Date, the following transactions occurred.

X formed FNewco2 with a cash contribution. FC4 elected under section 301-7701-3 to be treated as an unincorporated division of FC2 and distributed cash to FC2. FC2 sold the assets of FC4 to FNewco2. FC5 purchased certain Business A assets from FC6, a related Country C corporation. FC5 elected under section 301-7701-3 to be treated as an unincorporated division of FC3 and distributed cash to FC3. FC3 sold the assets of FC5 to FNewco2. X distributed FNewco2 to W, and W contributed FNewco2 to Y. W then spun Y off to W's shareholders.

Prior to the sales of FC4 and FC5 to FNewco2 by FC2 and FC3, respectively, FC4 and FC5 were treated as corporations for federal tax purposes. Pursuant to section 301.7701-3, FC4 and FC5 elected to be disregarded as entities separate from their owners (disregarded entities) for federal tax purposes, effective prior to the sales. FC2 and FC3 did not treat the income from the sales of the assets of FC4 and FC5, respectively, as FPHCI.

LAW AND ANALYSIS

Prior to the sales of FC4 and FC5, FC2, FC3, FC4 and FC5 were CFCs. Sections 957(a) and 958(a). The elections of FC4 and FC5 to be disregarded entities caused them to liquidate for U.S. tax purposes. Because their sole shareholders, FC2 and FC3, are corporations, the liquidations are nonrecognition events for FC4 and FC5, as well as for FC2 and FC3, under sections 332 and 337. *See* section 7.367(b)-5(c).

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 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 —
>
> (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 income. Section 1.954-2(e)(3) excludes from FPHCI gain from the sale of those assets, which do not give rise to any income, that are used, or held for use, in a trade or business. Specifically, section 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 —
>
> (i) ...
>
> (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

---

[1] Section 1221 prescribes the types of property that are not considered capital assets. Subparagraph (1) of that provision 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".

section 167 or 168 and the regulations under those sections (including tangible property described in section 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, section 1.954-2(a)(3) sets forth a specific time frame for examining the manner in which the property was so used or held. Section 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 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, 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 FC2 and FC3 were 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), *aff'd* 644 F.2d 879 (4th Cir. 1981), *cert. denied*, 454 U.S. 830 (1981) (quoting Folker v.

---

[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.

Johnson, 230 F.2d 906, 907 (2d Cir. 1956). "[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 [sic] 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 stated 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 reestablished 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 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 the disregarded entity elections of FC4 and FC5, FC2 and FC4, and FC3 and FC5, operated as separate corporations. FC4 engaged in Business A, while FC2 was a holding company. While FC3 engaged in Business B, it is unclear whether FC5 engaged in Business A (or any other business) or, rather, merely acquired all of its assets in the purchase of the Business A assets from FC6 immediately before the sale of FC5's assets by FC3. When FC4 and FC5 elected to be treated as disregarded entities, they effectively became branches or divisions of their owners, FC2 and FC3, respectively. *See* section 301.7701-2(a). As such, FC2 and FC3 are then deemed to have the assets owned by FC4 and FC5, respectively. While FC2 and FC3 are deemed to have the assets owned by FC4 and FC5, FC2 and FC3 must nevertheless use, or hold for use, such assets for the

---

[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 section 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 section 1.954-2(e)(3)(ii) and section 1231(b)(1) refer to the rules for depreciable property used in a trade or business.

requisite period of time in FC2's and FC3's trades or businesses before FC2 and FC3 are allowed to exclude from FPHCI the gain from the sales of those assets.

The trades or businesses, if any, in which FC4 and FC5, used, or held for use, the subject assets, prior to the disregarded entity elections, cannot be attributed to FC2 and FC3. Further, the assets purchased by FC5 from FC6 appear to have been sold by FC3 shortly after they were purchased by FC5 pursuant to a prearranged plan. Therefore, the assets purchased from FC6 are not assets used or held for use in a trade or business by FC5. These conclusions are supported by the language in section 1.954-2(a)(3), as well as the case law. Under section 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 corporations, FC2 and FC3, used or held for use the subject assets, rather than the entities 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 (citations omitted).

Acro Manufacturing Co. v. Commissioner, 39 T.C. 377 (1962), *aff'd* 334 F.2d 40 (6th Cir. 1964), *cert. denied* 379 U.S. 40 (1964), stands for a similar principle. In Acro, a parent corporation which was in a different trade or business than its wholly-owned subsidiary, liquidated the subsidiary receiving nonrecognition treatment under section 332. On the date of liquidation, the assets of the liquidated subsidiary were sold to a third party at a loss. The taxpayer argued that the loss should receive ordinary rather than capital loss treatment. It claimed that in a section 332 liquidation the character of the assets (as trade or business assets) passes to the parent upon liquidation of the subsidiary unchanged by the liquidation. The Tax Court rejected this position and identified the key question as being the tax nature of the assets in the parent's hands, not in the hands of the subsidiary. The Tax Court held that, because the parent was not in the business of the liquidated subsidiary and owned the assets for a minimal transitory period, capital loss resulted from the sale of the subsidiary's assets on the day it liquidated.

FC2 and FC3 were committed to sell FC4 and FC5 as part of a prearranged plan to spin-off Business A to U's shareholders before FC4 and FC5 elected to be disregarded entities. It appears that FC2 and FC3 held the assets for a short,

transitory period. In addition, the only trade or business assets owned by FC5 may have been the Business A assets purchased from FC6 just prior to the sale of FC5's assets by FC3. In that case, FC5 was not engaged in a trade or business. Whether or not FC5 was engaged in Business A, the assets purchased from FC6 are not assets used or held for use in a trade or business by FC5. Such conduct establishes that neither FC2 nor FC3 intended to continue operating the trades or businesses of FC4 and FC5 once FC4 and FC5 became branches of FC2 and FC3 through the disregarded entity elections. The transactions by which the assets were obtained by FC2 and FC3 were not undertaken for purposes of engaging in or establishing trades or businesses by FC2 and FC3. Therefore, FC2 and FC3 were not engaged in the same or similar trades or businesses as FC4 and FC5 during the time they held the assets of FC4 and FC5.

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. The Tax Court in Acro rejected the taxpayer's argument that the parent owned, operated and used in its business the assets during the short period between the subsidiary's liquidation and the sale of the assets on the same day. The Court found that the ownership for such a minimal, transitory period is insufficient to establish "use" of the distributed assets in the parent's business or to place the parent in the business of the former subsidiary. 39 T.C. at 384.

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 the case of FC2 and FC3, their intent in acquiring and holding the assets of FC4 and FC5 was to sell those assets to a related party as part of a prearranged plan, rather than employ such assets in the trades or businesses of FC2 and FC3. As such, the assets have no relationship to the trades or businesses of FC2 and FC3 since FC2 and FC3 are not continuing or engaging in present or future activities related to the particular field of endeavor of FC4 and FC5 (or FC6). Therefore, FC2 and FC3 did not use, or hold for use, the assets of FC4 and FC5 in the manner required by section 1.954-2(e)(3) and for the requisite holding period under section 1.954-2(a)(3).

While the above analysis clearly demonstrates that FC2 and FC3 have FPHCI, it should be noted that other arguments may be available to reach the same conclusion.

[redacted]

Please call if you have any further questions.

Phyllis Marcus
Chief

By: _____
PHYLLIS MARCUS
Chief, Branch 2
Office of Associate Chief Counsel
(International)