



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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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 October 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

USParent	=
FSub1	=
FSub2	=
FSub3	=
x%	=
y%	=
z%	=
Type A	=
Country B	=
FC	=
Year1	=
Year2	=
Year7	=
Year9	=
FCa	=
FCb	=

ISSUE

When, for foreign tax law purposes, a foreign corporation surrenders losses to a related foreign corporation that uses the losses to reduce its foreign tax liability, and no payment is made in exchange, is the surrender treated as a transfer of value for U.S. tax purposes, resulting in a distribution or capital contribution?

CONCLUSION

We continue to adhere to the approach to this problem adopted in GCM 39367 (Dec. 31, 1984). Consequently, a surrender of losses without a payment in exchange for the losses does not give rise to a constructive distribution or capital contribution. If the profitable corporation does make a compensatory payment to the loss corporation, the payment is treated for U.S. tax purposes as a capital contribution if the profitable corporation is the parent of the loss corporation, as a distribution if the profitable corporation is a subsidiary of the loss corporation, and as a distribution followed by a capital contribution if the profitable corporation and loss corporation are brother-sister corporations.

FACTS

USParent wholly owns USSub and FSub1. USSub and FSub1 own x% and y%, respectively, totalling all of the stock of FSub2. FSub1 formed FSub3 in Year 1, contributing certain assets and liabilities in exchange for all of FSub3's common stock. During Year 7, FSub2 purchased z% of the FSub3 common stock from FSub1.¹ FSub2 also purchased redeemable preferred stock issued by FSub3. FSub1, FSub2, and FSub3 are controlled foreign corporations that are organized under the laws of Country B and that use the FC as their functional currency.

FSub3 qualifies as a Type A corporation under Country B law. Country B law permits a Type A corporation to renounce exploration and development expenses to Country B shareholders of the corporation provided certain conditions are met. During Year 2 through Year 7, FSub3 renounced over FCa million of expenses to FSub1. During Year 7 through Year 9, FSub3 renounced over FCb million of expenses to FSub2. Neither FSub1 nor FSub2 made any payment to FSub3 on account of the renounced expenses, which were applied to reduce the Country B

¹ We note that FSub2's purchase of the FSub3 common stock raises potential section 304 issues, which we have not considered as part of our advice.

tax liabilities of FSub1 and FSub2. FSub3 had a deficit in its earnings and profits for U.S. tax purposes during Year 1 through Year 9.

LAW AND ANALYSIS

GCM 39367 addresses the characterization of a payment from a profitable foreign corporation to a related foreign corporation that is made to compensate the payee corporation for use of the payee corporation's losses to reduce the payor corporation's foreign tax liability. GCM 39367 concludes that such a payment constitutes a capital contribution, if the profitable corporation is the parent of the loss corporation; a dividend (assuming sufficient earnings and profits), if the profitable corporation is a subsidiary of the loss corporation; and a dividend (assuming sufficient earnings and profits) followed by a capital contribution, if the profitable corporation and loss corporation are brother-sister corporations. This conclusion is based on the theory that, under general U.S. tax principles, the surrender of losses for foreign tax law purposes by one corporation to a second corporation is not a transfer of value from the first corporation to the second corporation. GCM 39367 further concluded that the foreign corporations' U.S. shareholders, in calculating the foreign corporations' earnings and profits for U.S. tax purposes, could not elect to apply U.S. consolidated return regulations governing the allocation of U.S. federal income tax liability among members of a consolidated group. These regulations permit consolidated groups to elect to treat compensatory payments among affiliated group members for the use of tax losses as not resulting in dividends or capital contributions.

The analytical approach adopted in GCM 39367 is that a surrender of losses by one foreign corporation to a related foreign corporation for foreign tax law purposes does not constitute a transfer of value by the loss corporation to the profitable corporation. Under this view, if a payment is made in exchange for the losses, as was the case in GCM 39367, the payment is considered to be unsupported by consideration and is treated as a distribution, capital contribution or distribution followed by a capital contribution. Conversely, because the profitable corporation is not considered to receive anything of value from the loss corporation, a surrender of losses without a compensatory payment does not result in a distribution, capital contribution or combination thereof.

You asked us to reconsider the position taken in GCM 39367 as applied to the facts of this case. You asked whether a surrender of losses by one foreign corporation to a related foreign corporation for foreign tax law purposes should be viewed as a transfer of value from the loss corporation to the profitable corporation. Under this view, a surrender of losses without a payment by the profitable corporation for use of the losses would be treated as a distribution of a valuable asset (i.e., the right to reduce foreign tax liability), if the loss corporation were the subsidiary of the

profitable corporation; a capital contribution, if the loss corporation were the parent of the profitable corporation; or a distribution followed by a capital contribution, if the loss corporation and profitable corporation were brother-sister corporations. The amount of any such distribution or capital contribution would be equal to the value of the losses (*i.e.*, equal to the foreign tax savings resulting from use of the losses). If the profitable corporation paid the loss corporation for use of the losses, the surrender would be treated as a transfer of cash for value to the extent the payment did not exceed the foreign tax savings resulting from use of the losses.

Losses surrendered by one foreign corporation to a related foreign corporation for foreign tax purposes have value only to the extent that foreign law permits the transferee to use the losses to reduce its foreign tax liability. In our view, a transferee corporation's ability to use the losses and thereby reduce its foreign tax liability represents a benefit conferred by the foreign taxing authority. It does not represent value derived from the loss corporation. Accordingly, it is inappropriate to treat a surrender of losses as the transfer of an asset by the loss corporation. *Cf.* Rev. Proc. 80-18, 1980-1 C.B. 623; *Xerox Corporation v. United States*, 41 F.3d 647 (Fed. Cir. 1994), *reh'g denied*, U.S. App. LEXIS 3101 (Feb. 7, 1995), *cert. denied*, 116 S.Ct. 72 (1995), *nonacq.*, 1997-1 C.B. 1; *Compaq Computer Corp. v. Commissioner*, 113 T.C. No. 25 (Nov. 18, 1999)(each involving a transfer of U.K. tax credits attributable to refunded advance corporation tax between related foreign corporations, which was not viewed as a transfer of value); Rev. Rul. 58-296, 1958-1 C.B. 276 (holding that a privilege created by an administrative agency was not "property" for purposes of section 1221).

In reaching this conclusion, we are mindful that treating a surrender of losses as the transfer of an asset from the loss corporation to the profitable corporation for U.S. tax purposes would create uncertainty and complexity in accounting for such transactions. For example, under the transfer of value theory, if a foreign corporation surrenders losses to its foreign parent corporation without compensation, the surrender of the losses would be treated as the distribution of an asset (*i.e.*, the right to foreign tax savings) in which the loss corporation presumably would have no basis for U.S. tax purposes. Adjustments to the tax balance sheet and earnings and profits or capital accounts of both corporations to account for the distribution of this zero-basis asset and its extinguishment upon being applied to satisfy a hypothetical pre-surrender foreign tax liability of the parent corporation would be required. There are no U.S. tax accounting rules specifically addressing this situation, which has no direct analogue in U.S. tax law since tax losses affecting U.S. tax liability may be shared only by members of the same consolidated group. In contrast, well-settled U.S. tax principles may be applied to account for actual cash transfers made in connection with such foreign law elections as dividends or capital contributions.

Therefore, we continue to believe the better view is that reflected in GCM 39367, i.e., that a transfer of losses does not constitute a transfer of value from the loss corporation to the profitable corporation. Consequently, a transfer of losses for foreign tax law purposes without a payment in exchange therefor does not give rise to a constructive distribution or capital contribution. If the profitable corporation makes a payment to the loss corporation to compensate it for use of the losses, the payment is a capital contribution if the profitable corporation is the parent of the loss corporation, a distribution if the profitable corporation is a subsidiary of the loss corporation, and a distribution followed by a capital contribution if the profitable corporation and loss corporation are brother-sister corporations. We also agree with the GCM's conclusion that the detailed provisions of the U.S. consolidated return regulations governing the allocation of U.S. tax liability may not be applied by analogy to such transfers of foreign tax attributes among foreign corporations.

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

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