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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR: Thomas J. Smith, Industry Director, Heavy  
Manufacturing, Construction and Transportation,  
LM:MCT, attn. Karen S. Ammons, Director, Field  
Operations.

FROM: Irwin Halpern  
Senior Technical Reviewer, CC:INTL:Br3

SUBJECT:

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duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Chief Counsel Advice.

LEGEND:

Parent =

Seller =

Target =

Date 1 =

Date 2 =

Purchasing Corporation =  
U.S. Sub1 =

U.S. Sub2 =  
U.S. Sub3 =

F Sub1 =

X =

Country Y =

Country Z =

PURPOSE:

By a letter dated December 8, 1998, Parent, a taxpayer within your examination jurisdiction, submitted a private letter ruling request to our Office. Parent supplemented its private letter ruling request by letters dated December 30, 1998, January 12, 1999, May 13, 1999, and August 10, 1999. Parent's submission requested a ruling with regard to elections under section 338(g) for certain foreign subsidiaries that are part of a group of corporations sold by Seller, an affiliate of Parent. The submission requested a ruling that the current and accumulated earnings and profits ("E&P") of those subsidiaries not derived as a result of the section 338(g) elections be viewed as distributed to the Parent's consolidated group under section 902 and 1248 before the E&P derived as a result of the section 338 deemed asset sales. By letter dated August 23, 1999, Parent withdrew its

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private letter ruling request. In accordance with section 8.07(2)(b) of Rev. Proc. 2000-1, the purpose of this memorandum is to notify you of Parent's withdrawal of its request for a private letter ruling. In addition, this memorandum states our views of the issue raised by Parent's request.

ISSUE:

If a section 338(g) election is made in connection with the acquisition of the stock of a foreign corporation, does section 338(h)(16) affect the computation of a selling shareholder's deemed-paid taxes under sections 902 and 1248?

CONCLUSION:

No. Section 338(h)(16) does not affect the computation of a selling shareholder's deemed-paid taxes under sections 902 and 1248. Accordingly, changes to a foreign corporation's post-1986 undistributed earnings or to a selling shareholder's section 1248 deemed dividend that result from a deemed asset sale are taken into account in computing the selling shareholder's deemed-paid taxes under sections 902 and 1248.

FACTS:

Based on Parent's submissions, we understand the facts as follows. Parent is a publicly held domestic corporation that owns 100 percent of the shares of Seller, another domestic corporation. Prior to the sale at issue, Seller owned 100 percent of the shares of Target, a third domestic corporation. Target owns 100 percent of the stock of a number of foreign subsidiaries incorporated in X, a U.S. possession. Target also owns 100 percent of the stock of a dual resident corporation, U.S.Sub1, and two domestic corporations, U.S. Sub2 and U.S. Sub3. U.S. Sub1 is a holding company for a number of Country Y foreign subsidiaries. U.S. Sub2 and U.S. Sub3 collectively own 99.9 percent of the stock of F Sub1, a Country Z corporation that operates as a holding company for a number of Country Z subsidiaries. All domestic and dual resident corporations in the Parent group filed a consolidated federal income tax return.

Pursuant to an asset purchase agreement of Date 1, Seller agreed to sell all of the stock of Target and certain other assets to Purchasing Corporation, an unrelated domestic corporation. Parent and Purchasing Corporation agreed to make elections under section 338(g) and 338(h)(10) with respect to Target, U.S. Sub2

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and U.S. Sub3.<sup>1</sup> Parent and Purchasing corporation further agreed that Purchasing Corporation may make elections under section 338(g) with respect to the first-tier and lower-tier foreign subsidiaries of Target unless such elections result in a significant cost to Parent or its affiliates.

The potential “significant cost” that concerned Parent, and the matter addressed in its private letter ruling request, involves the interaction between the potential section 338(g) elections for Target’s foreign subsidiaries and the computation of the Parent consolidated group’s section 902 deemed-paid taxes with respect to deemed sales of foreign subsidiary stock. Parent anticipated that, prior to any deemed asset sales by the foreign subsidiaries under section 338(g), each of the foreign subsidiaries would have current and accumulated E&P in an amount less than the gain recognized on its stock. However, Parent anticipated that the E&P generated by the section 338(g) deemed asset sales would cause each of the foreign subsidiaries’ current and accumulated E&P to exceed the gain recognized on its stock.

The Target’s foreign subsidiaries constitute controlled foreign corporations (“CFCs”). In the January 12, 1999 supplement to its private letter ruling request, Parent represented that it does not believe that the making of section 338(g) elections with respect to any of Target’s foreign subsidiaries would give rise to subpart F income.

Seller’s sale of Target and its subsidiaries to Purchasing Corporation closed on Date 2.

LAW:

1. Section 338

Section 338 provides that purchasing corporations that make a “qualified stock purchase” of at least 80 percent of the stock of a target corporation may make either of two elections that will result in a deemed sale of the target corporation’s assets. The first is a regular section 338(g) election. If the purchasing corporation makes a section 338(g) election, the “old” target is considered to sell all of its assets to a “new” target corporation as of the close of the acquisition date and is required to recognize gain or loss on its assets. See section 338(a). New target is

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<sup>1</sup> Parent’s submission did not explicitly state whether it and Purchasing Corporation agreed to make section 338(g) and 338(h)(10) elections with respect to U.S. Sub1. However, Parent’s inclusion of U.S. Sub1 in the submitted facts indicates that such elections were contemplated.

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treated as acquiring old target's assets as of the beginning of the day after the acquisition date. Id. New target does not succeed to old target's E&P accounts. See Treas. Reg. § 1.338-1T(b). Target's shareholders recognize gain or loss with respect to their target stock. Section 1001(c).

Section 338(h)(10) permits a second type of election when the target is a member of a consolidated group.<sup>2</sup> If a section 338(h)(10) election is made, an old target corporation is treated as selling its assets to a new target corporation while old target is still a member of the seller's group. Treas. Reg. § 1.338(h)(10)-1T(d)(3). Old target is generally deemed to liquidate following the deemed asset sale. See Treas. Reg. §§ 1.338-1T(a)(1) and 1.338(h)(10)-1T(d)(4)(i) and -1T(d)(5)(i). Unlike a regular section 338(g) election, target's shareholders do not recognize gain or loss on the stock sale. Treas. Reg. § 1.338-1T(d)(5)(iii). An election under section 338(h)(10) is not available for foreign target corporations. See Treas. Reg. § 1.338(h)(10)-1T(b)(3), -1T(b)(4) and -1T(c)(1).

If either a section 338(g) or a section 338(h)(10) election is made for a target corporation, additional "trickle-down" section 338 elections may be made with respect to lower-tier subsidiaries of the target. See section 338(h)(3)(B); Treas. Reg. §§ 1.338-3T(b)(4) and 1.338(h)(10)-1T(d)(3)(ii) and -1T(d)(4)(ii). A section 338 election made with respect to a lower-tier subsidiary will trigger a deemed sale of the subsidiary's assets. Generally, no gain or loss will be recognized with respect to the stock of the lower-tier subsidiary unless the lower-tier subsidiary is a first-tier foreign subsidiary of a domestic corporation. See Treas. Reg. § 1.338-4T(h)(3) and -4T(h)(8), Ex. 4; see also section 338(h)(16) (second sentence) (providing rules concerning the treatment of this gain for purposes of the foreign tax credit).

## 2. International Code Provisions

Section 901(a) permits a taxpayer to elect to credit income taxes paid or accrued to a foreign country against the taxpayer's U.S. federal income tax.

Section 904 imposes a limit on the amount of foreign income taxes that may be credited under section 901(a). Section 904(a) limits the amount of foreign income taxes that may be credited in any one taxable year to the amount of a taxpayer's pre-credit U.S. income tax on its foreign source taxable income (the "section 904 limitation"). In chart form, the section 904 limitation is as follows:

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<sup>2</sup> A section 338(h)(10) election is also available when the target is an affiliate of the seller or an S corporation. Treas. Reg. § 1.338(h)(10)-1T(c)(1).

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$$\text{Limit} = \text{Pre-Credit U.S. Income Tax} \times \frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}}$$

The section 904 limitation is calculated separately for different categories of foreign source taxable income. Section 904(d).

Section 902(a) provides that a domestic corporation that owns at least ten percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year will be deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes. The portion of such taxes that a domestic corporation will be deemed to have paid in any taxable year is determined by the ratio of the dividends received by the domestic corporation during the taxable year to the foreign corporation's post-1986 undistributed earnings (the "section 902 fraction"). Section 902(a). In chart form, the deemed-paid tax calculation is as follows:

$$\text{Deemed-Paid Tax} = \text{Post-1986 Foreign Income Taxes} \times \frac{\text{Dividend Paid}}{\text{Post-1986 Undistributed Earnings}}$$

The amount of taxes a domestic corporation is deemed to pay under section 902, together with foreign income taxes the domestic corporation pays directly, are creditable under section 901(a), subject to the section 904 limitation. See section 901(a). If the foreign corporation paying the dividend is a CFC, the amount of foreign income taxes the domestic corporation is deemed to pay is computed separately with respect to the CFC's post-1986 undistributed earnings in each section 904(d) category out of which the dividends are paid. Treas. Reg. § 1.902-1(d)(1).

When a domestic corporation disposes of stock in a foreign corporation, gain recognized on the disposition is generally U.S. source income or foreign source passive income. See sections 865 and 904(d)(2)(A). The treatment of the gain may differ, however, when the foreign corporation is a CFC. Under section 1248, if a U.S. shareholder that owns ten percent or more of the voting power of a CFC disposes of stock in the CFC, gain recognized on the disposition is treated as a dividend to the extent of the CFC's E&P attributable to the stock. Section 1248(a).<sup>3</sup>

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<sup>3</sup> For purposes of determining the amount of a CFC's E&P, the E&P of lower-tier foreign subsidiaries is taken into account in certain circumstances. Section 1248(c)(2). If the E&P of any lower-tier foreign subsidiary is taken into account, the portion of the deemed dividend attributable to the E&P of such subsidiary is treated as a dividend paid by

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The portion of the stock gain that is considered to be a dividend is generally foreign source income. Section 862(a)(2); but see section 904(g). The section 904(d) category for the deemed dividend is determined pro rata based on the CFC's E&P in each category. See section 904(d)(3); Treas. Reg. §§ 1.904-5(c)(4). In addition, the deemed dividend is eligible to carry deemed-paid taxes under section 902. Treas. Reg. §§ 1.902-1(a)(11) and 1.1248-1(d)(1).

### 3. Interaction Between Section 338 and the International Code Provisions

If a purchasing corporation makes a section 338(g) election with respect to a foreign target, gain or loss on the deemed asset sale increases or decreases the foreign target's E&P. See Treas. Reg. § 1.338-9(b)(1). Target's shareholders are considered to own target stock through the close of the acquisition date. Treas. Reg. § 1.338-9(b)(2). Accordingly, the taxation of target's shareholders is determined by taking into account any increase or decrease in the foreign target's E&P. Treas. Reg. § 1.338-9(b)(1). For example, a change in the foreign target's E&P is taken into account in computing the amount of any dividend deemed paid to a selling shareholder under section 1248. Id. Deemed sale gain and corresponding E&P are also taken into account for purposes of sections 551, 951 and 1293. Id.

Section 338(h)(16) limits the foreign tax credit consequences that would otherwise result from a section 338 election. It provides as follows:

(16) Coordination With Foreign Tax Credit Provisions. - Except as provided in regulations, this section will not apply for purposes of determining the source or character of any item for purposes of [sections 901 through 908] (relating to the foreign tax credit). The preceding sentence shall not apply to any gain to the extent such gain is includible in gross income as a dividend under section 1248 (determined without regard to any deemed sale under this section by a foreign corporation).

The legislative history to section 338(h)(16) describes the operation of the provision as follows:

Under the bill, a deemed asset sale under section 338 shall generally be disregarded for source and foreign tax credit limitation purposes in determining the seller's foreign tax credit limitation, except as provided in

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the subsidiary directly to the selling shareholder. See Treas. Reg. § 1.1248-1(d)(1).

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regulations. Instead, for these purposes, the gain is generally treated as a gain from the sale of the stock. An exception to this rule is provided for gain derived from the deemed sale by a U.S. corporation of stock in a controlled foreign corporation, to the extent that the gain is treated as dividend income under section 1248 (before any deemed sale by the controlled foreign corporation of *its* assets). To that extent, income derived from the sale of stock of the U.S. corporation is treated, for foreign tax credit purposes, as income from the sale of the U.S. corporation's assets.

H.R. Rep. 100-795, at 314-15 (1988); S. Rep. No. 100-445, at 334 (1988); see also Joint Committee on Taxation, Description of the Technical Corrections Act of 1988, at 329-30 (1988) (same language).

Analysis:

The issue presented by Parent's withdrawn private letter ruling request is whether section 338(h)(16) affects the computation of the Parent consolidated group's section 902 deemed-paid taxes with regard to deemed sales of foreign subsidiary stock. For the reasons stated below, we conclude that section 338(h)(16) does not affect this computation.

The first sentence of section 338(h)(16) limits the paragraph's application to determinations of "source and character." "Source" generally refers to whether income is derived from within or without the United States, and "character" generally is understood to refer to the separate section 904(d) categories. See, e.g., Treas. Reg. § 1.338-4T(h)(8), Ex. 4; Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 874 n.11, 879, 908 (1987); Notice 87-6, 1987-1 C.B. 417. Thus, section 338(h)(16) ignores a deemed asset sale solely for purposes of determining the source of an item and the section 904(d) separate category to which an item belongs. It does not disregard a deemed asset sale for purposes of determining the amount of any item.

The amount of deemed-paid taxes associated with a selling shareholder's section 1248 dividend is determined by the selling shareholder's section 902 fraction. The denominator of the section 902 fraction is the amount of the foreign target's post-1986 undistributed earnings. The numerator of the section 902 fraction is the amount of the selling shareholder's deemed dividend under section 1248. Because section 338(h)(16) is limited to determinations of source and character, the provision does not apply in determining the amount of a foreign target's post-1986 undistributed earnings or the amount of a selling shareholder's deemed dividend under section 1248 for purposes of computing a selling shareholder's deemed-paid taxes under section 902. Thus, section 338(h)(16) does not affect the computation

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of these amounts for purposes of determining a selling shareholder's section 902 fraction.

A foreign corporation's post-1986 undistributed earnings are determined by reference to the foreign corporation's E&P, as calculated pursuant to section 964(a). See section 902(c)(1); Treas. Reg. § 1.902-1(a)(9). Section 964(a) incorporates the generally applicable domestic rules governing E&P. See Treas. Reg. § 1.964-1(a). Under these rules, gain or loss on a deemed asset sale is taken into account in determining the amount of a target corporation's E&P. See sections 338(a)(1) and 312(f)(1); Treas. Reg. §§ 1.338-2T(c)(7) and -2T(c)(10). Because section 338(h)(16) applies solely to determinations of source and character, the generally applicable E&P rules continue to apply in determining the amount of a foreign target's post-1986 undistributed earnings. See Treas. Reg. § 1.338-9(b)(1) (deemed sale gain and corresponding E&P taken into account in determining the taxation of the foreign target and its shareholders). Thus, for purposes of computing a selling shareholder's deemed-paid taxes under section 902, the amount of a foreign target's post-1986 undistributed earnings reflects any increase or decrease in the foreign target's E&P resulting from a deemed asset sale under section 338(g).<sup>4</sup>

The numerator of a selling shareholder's section 902 fraction is its section 1248 deemed dividend. Treas. Reg. § 1.901-1(a)(11). The section 1248 deemed dividend, in turn, is determined by reference to the foreign target's E&P. Section 1248(a). As stated, a foreign target's E&P is computed according to generally applicable domestic rules, which require taking deemed sale gain into account in

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<sup>4</sup> In cases where an increase in the amount of a section 1248 deemed dividend is limited by the amount of built-in gain on the foreign target's stock, a section 338(g) election may result in reducing the amount of foreign taxes a selling shareholder would otherwise be deemed to pay under section 902. Symmetrically, in cases where a deemed asset sale generates a loss, a section 338(g) election may result in increasing the amount of foreign taxes a selling shareholder would otherwise be deemed to pay under section 902. This is the consequence of the fictional asset sale created by section 338 and the fact that the computation of E&P under section 964(a) follows U.S. tax principles and does not attempt to reflect the foreign tax base. See United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989) (holding that domestic principles govern, and U.K. law is not relevant in calculating "accumulated profits," the denominator in the section 902 formula during the years at issue). Section 338(h)(16) does not, and was not intended to, affect these consequences of a section 338(g) election.

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determining a target corporation's E&P. See also section 1248(c)(1). Accordingly, the effect of a deemed asset sale on a foreign target's E&P is taken into account in determining the portion of a selling shareholder's stock gain that is treated as a dividend under section 1248. Treas. Reg. § 1.338-9(b)(1); H.R. Rep. 100-795, at 315; S. Rep. No. 100-445, at 334-35. Because section 338(h)(16) is limited to determinations of source and character, it does not affect the amount of the section 1248 deemed dividend for purposes of computing a selling shareholder's deemed-paid taxes under section 902. Consequently, for such purposes, the amount of a selling shareholder's section 1248 deemed dividend reflects any increase or decrease in the foreign target's E&P resulting from a deemed asset sale under section 338(g).

If the foreign target is a CFC, a selling shareholder must compute its deemed-paid taxes under section 902 separately with respect to the CFC's post-1986 undistributed earnings in each section 904(d) category out of which any section 1248 deemed dividend is considered to be paid. Treas. Reg. § 1.902-1(d)(1). This raises a potential question as to whether, under section 338(h)(16), the numerator or denominator of the section 902 fraction should be viewed as an "item" whose "character", *i.e.*, section 904(d) separate limitation category, must be determined without regard to any deemed asset sale pursuant to section 338(g). However, it would be contradictory to determine the character of an item that is required to be adjusted by a deemed asset sale, such as the foreign target's post-1986 undistributed earnings, without regard to the deemed asset sale. Similarly, we note that there is no authority for Parent's suggested ordering rule whereby current and accumulated E&P would be viewed as distributed prior to deemed sale E&P.<sup>5</sup> Such an ordering rule would contradict the above-discussed section 964(a) and section 1248 authorities. Moreover, as discussed below, the purpose of section 338(h)(16) is to prevent a selling shareholder from obtaining an unwarranted increase in its section 904 limitation. There is no evidence that section 338(h)(16) was intended to apply for purposes of computing a selling shareholder's deemed-paid taxes under section 902. Accordingly, for purposes of section 902, it is inappropriate to treat a foreign target's post-1986 undistributed earnings or a selling shareholder's section 1248 deemed dividend as an item whose character must be determined without regard to any deemed asset sale under section 338(g).

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<sup>5</sup> In contrast, at the selling shareholder level, the rule of section 338(h)(16) can be articulated as an ordering rule, whereby the selling shareholder's stock gain is recharacterized under section 1248 first by reference to the foreign target's current and accumulated E&P (which is not subject to section 338(h)(16)), and second by reference to the deemed sale E&P (which is subject to section 338(h)(16)). See, e.g., Treas. Reg. § 1.338-4T(h)(8), Ex. 4.

The legislative history to section 338(h)(16) supports the conclusion that section 338(h)(16) does not apply for purposes of computing a selling shareholder's deemed-paid taxes under section 902. The legislative history indicates that section 338(h)(16) was enacted to prevent a selling shareholder from obtaining an unwarranted increase in its section 904 limitation. Specifically, it indicates that the provision was intended to prevent a selling shareholder from using a deemed asset sale election to convert what would ordinarily constitute U.S. source income or foreign source passive income into foreign source income in a preferred section 904(d) category. See H.R. Rep. No. 100-795, at 314-15; S. Rep. No. 100-445, at 334-35; H.R. Conf. Rep. No. 100-1104, at 13 (1988); see also Preamble to Prop. Treas. Reg. § 1.338-4 and -5, 57 Fed. Reg. 1409, 1413 (1992).<sup>6</sup> This ability to alter the source and character of stock gain through a deemed asset sale election enabled a selling shareholder to increase its foreign source taxable income in a given section 904(d) category without incurring any corresponding foreign tax.<sup>7</sup> This, in turn, allowed the selling shareholder to credit unrelated foreign taxes imposed on income in that category that could not otherwise be credited due to the shareholder's section 904 limitation with respect to that category. Congress considered this result to be contrary to the purposes of the foreign tax credit provisions. See H.R. Rep. No. 100-795, at 314; S. Rep. No. 100-445, at 334; see also Preamble to Prop. Treas. Reg. § 1.338-4 and -5, 57 Fed. Reg. 1409, 1413. Accordingly, Congress enacted section 338(h)(16) to prevent a selling shareholder from utilizing a deemed asset sale election to achieve this result. See H.R. Rep. No. 100-795, at 314 (stating that under the bill, a deemed asset sale will generally be disregarded for source and foreign tax credit limitation purposes in determining the selling shareholders' foreign tax credit limitation); S. Rep. No. 100-445, at 334 (same). There is no indication in the legislative history that Congress was

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<sup>6</sup> Prior to the enactment of section 338(h)(16), this conversion could be achieved by making a section 338(g) election in connection with the disposition of a CFC because E&P generated by deemed sale gain would increase the portion of the selling shareholder's stock gain treated as a deemed dividend under section 1248 and, thereby, increase the portion of the stock gain subject to the source and section 904(d) separate category rules for dividends. Conversions in the source and section 904(d) category of stock gain could also be achieved by making a section 338(h)(10) election with respect to a domestic target that held assets whose deemed sale would generate foreign source income.

<sup>7</sup> It is unlikely that a foreign jurisdiction would impose tax on a stock sale for which a section 338 election is made since the foreign jurisdiction will generally respect the form of the transaction as a stock sale.

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concerned with the computation of a selling shareholder's deemed-paid taxes under section 902.

The fact that section 338(h)(16) does not include section 960(a) within its scope is further evidence that Congress did not intend to affect the computation of a selling shareholder's deemed-paid taxes under section 902. Section 960(a) generally permits a domestic corporation required under section 951(a) to include in income undistributed earnings of a CFC, a credit for foreign income taxes paid by the CFC parallel to the credit that would have been allowed under section 902 if the earnings had actually been distributed as a dividend. The computational rules for section 902 and section 960(a), including the rules for determining a foreign corporation's post-1986 undistributed earnings, are generally the same. See Section 960(a); Treas. Reg. § 1.960-1(i)(3). Consequently, the absence of any reference to section 960(a) indicates that Congress did not have section 902 in mind when it enacted section 338(h)(16).

Finally, our conclusion is supported by differences in the policies underlying section 902 and the policies underlying the source and separate category rules of sections 865 and 904(d). The source rules reflect the view that an item of income or gain should not enable a taxpayer to claim foreign tax credits unless the item is subject to foreign tax. See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 918. The separate category rules reflect the view that foreign taxes imposed on one category of income should not be used to reduce U.S. tax that would otherwise be due on other low-taxed categories of income. H.R. Rep. No. 99-426, at 333-35 (1985); S. Rep. No. 99-313, at 302-3 (1986). Section 338(h)(16) furthers these policies by preventing a taxpayer from utilizing a section 338 election, in connection with a stock disposition unlikely to trigger a foreign income tax, to increase its allowable foreign tax credits and, thereby, reduce U.S. tax that would otherwise be due on gain from the stock disposition. In contrast, applying section 338(h)(16) to disregard a change in a foreign target's E&P attributable to the deemed sale of its assets would be inconsistent with the policies underlying the section 902 fraction. As discussed above, the computations of a foreign target's post-1986 undistributed earnings and a selling shareholder's section 1248 deemed dividend follow U.S. tax principles without regard to the foreign tax base and, as a result, take into account changes in the foreign target's E&P resulting from a deemed asset sale.

For the forgoing reasons, we conclude that section 338(h)(16) does not affect the computation of a selling shareholder's deemed-paid taxes under sections 902 and 1248. Thus, the deemed sale of Target's foreign subsidiaries' assets pursuant to section 338(g) should be given effect for purposes of computing the Parent consolidated group's deemed-paid taxes under sections 902 and 1248. Any

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increase (or decrease) in the E&P of a foreign subsidiary resulting from a deemed asset sale should be reflected in both the numerator and the denominator of the selling shareholder's section 902 fraction. The following example illustrates the application of section 902 when a section 338(g) election is made for a foreign target.<sup>8</sup>

Example:

USS, a domestic corporation, owns 100 percent of the stock of T, a CFC. USS has a basis of \$0 in the stock of T. USS sells its T stock for \$400 to an unrelated domestic corporation, which elects under section 338(g) to treat the stock purchase as an asset purchase for U.S. tax purposes. T has general limitation post-1986 undistributed earnings of 50u, and has paid \$10 in foreign income taxes with respect to such earnings. The deemed sale of T's assets results in additional general limitation earnings of 450u. USS recognizes a \$400 gain on the sale of T stock, all of which is recharacterized as a deemed dividend under section 1248. Treas. Reg. § 1.338-9(b)(1). The amount of foreign income taxes attributable to general limitation income that is deemed paid by USS under section 902 is computed as follows:

$$\text{Deemed-Paid Tax} = \frac{400u}{500u} \times \$10 = \$8$$

Under section 338(h)(16), USS's \$400 gain is comprised of \$50 of foreign source general limitation income and \$350 of foreign source passive income for purposes of determining USS's section 904 limitation.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We understand that Parent is seeking a pre-filing agreement with regard to certain aspects of the sale of Target and its subsidiaries. Please feel free to contact our Office if you have any questions in connection with the pre-filing agreement, including the application of section 338(h)(16) in the event you discover that a

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<sup>8</sup> For simplicity, the example involves a first-tier foreign target with a "u" functional currency. However, the same rules apply with regard to deemed sales of foreign target corporations by domestic target corporations that are subject to elections under sections 338(g) and 338(h)(10) (such as in Parent's case). The example assumes that 1u = \$1 at all times and that stock gain is treated as foreign source income under the foreign affiliate rule of section 865(f). In addition, the example assumes that the deemed asset sale under section 338(g) does not give rise to subpart F income.

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section 338(g) election with respect to any of the foreign subsidiaries will generate subpart F income.

Parent may cite PLR 8938036 (June 27, 1989) in support of its position that the current and accumulated E&P of the foreign subsidiaries not derived as a result of the deemed asset sales be viewed as distributed under sections 902 and 1248 prior to E&P derived as a result of the deemed asset sales. However, PLR 8938036 did not address this issue. See footnote 5 above and accompanying text. Moreover, because Parent was not the recipient of PLR 8938036, Parent may not use or cite the ruling as precedent. Section 6110(k)(3).

If you have any further questions, please call 202-622-3850.

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