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

MEMORANDUM FOR DISTRICT COUNSEL, KANSAS-MISSOURI DISTRICT, ST. LOUIS

FROM: Jeffrey L. Dorfman
Branch Chief CC:INTL:BR5

SUBJECT:

This Field Service Advice responds to your memorandum dated November 5, 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:

P =
Date a =
Country A =

ISSUES:

(1) Whether the accounts receivable described below are appropriately treated as assets producing general limitation income pursuant to Step 3 of the DASTM computation under ' 1.985-3(e)(3)(iii).

(2) How is DASTM gain in excess of interest on related person indebtedness allocated among the section 904(d) baskets.

CONCLUSION:

(1) The classification of assets is based on the type of income such assets actually produce. Based on the facts presented, the accounts receivable are in substance single category assets that generate general limitation income. At most, the

accounts receivable are multiple category assets resulting in a marginal allocation of DASTM loss to the passive basket.

(2) DASTM gain on related party liabilities is allocated to passive foreign personal holding company income.

FACTS:

P is the parent of a group of affiliated corporations with which it files a consolidated return based on a fiscal tax year ended Date a. For the years at issue, P owned 100% of several controlled foreign corporations (CFCs) which operated in countries with hyperinflationary currencies. Accordingly, the CFCs were required to use the dollar as their functional currency and the dollar approximate separate transaction method of accounting (DASTM) for purposes of computing earnings and profits. ' 1.985-1(b)(2)(ii).

During the year at issue, several of P=s CFCs (Athe CFCs@) had trade account receivables denominated in the local hyperinflationary currency, which produced a loss under DASTM. For purposes of allocating DASTM loss (as fully explained below), P treated the receivables of the CFCs as an asset that generated income described in section 904(d)(1)(A) (passive income). P contends that this treatment is appropriate on the basis that the accounts receivable generated interest income. On review by the field, however, it was found that the amount of interest income generated by these receivables was de minimus and not designed to offset the effects of the hyperinflation. Rather, it appears that the P=s receivables were indexed for inflation.

In addition, one CFC was the issuer of related party liabilities which produced a DASTM gain in excess of related party interest under ' 1.985-3(e)(3)(vi). For purposes of properly characterizing such gain under section 904(d), P treated the amount of gain that exceeded related party interest expense as a contra-expense in arriving at net income or earnings and profits.

LAW AND ANALYSIS

ISSUE 1.

Section 1.985-3(e)(1) provides that DASTM gain or loss is allocated to the section 904(d) baskets under the 9-step method prescribed in ' 1.985-3(e)(3). Section 1.985-3(e)(3)(iii) provides that assets are characterized according to the source and type of income they generate by applying the principles of ' 1.861-9T(g)(3). Section 1.985-3(e)(3)(iii) contains an anti-abuse rule which provides that if a purpose of a taxpayer=s business practice is to manipulate asset characterization, the district director may require that none of the DASTM gain or loss be allocated to those assets. The regulation gives as an example the case of a taxpayer that begins to charge interest on account receivables to manipulate asset characterization. Section 1.861-9T(g)(3) provides that assets are characterized according to the source and type of income they generate. Assets are divided into 3 classes: (1) single category assets, (2) multiple category assets, and (3) assets without directly identifiable yield.

For purposes of step 3, P has treated the accounts receivable of the CFC at issue as an asset that generated exclusively section 904(d)(1)(A) passive income. P contends that this treatment is appropriate because the accounts receivable generate interest income. As a result, P contends the DASTM loss attributable to the accounts receivable reduces P=s passive rather than general basket income.

P argues that rampant inflation and rapidly devaluing currency in Country A during the period under examination caused customers to delay paying their bills. P states that, as a result, the CFC would include an interest factor in the price of the product ranging from 1,500% to 32%, depending on the customer and the fiscal year in question. The affiliates would record the invoices as sales revenues for that portion of the price relating to the product and as interest income for that portion of the price representing the interest factor.

However, an analysis by the field of the interest income of the CFC demonstrates that none of them reported interest income related to the receivables that exceeded 1.4% of gross sales in any year. The range of interest with respect to the receivables as a percentage of gross sales for the more active CFCs for the period is from .4% to 1.4%. Assuming this analysis to be correct, such marginal amounts of interest were not an economic offset to anticipated hyperinflation and should not be used to characterize the entire DASTM loss related to the receivable.

Given the de minimus amount of interest, the receivables are in substance a single category asset and any DASTM loss attributable to the receivable should be allocated exclusively to the category of income derived from the receivable (i.e., the general basket). At most, the interest bearing receivables could be considered multiple category assets for purposes of ' 1.985-3. Thus, a marginal percentage of the DASTM loss computed with respect to the receivables could be attributed to the interest income, determined under the principles of ' 1.861-9T(g)(3), and allocated to the section 904(d)(1)(A) passive basket. We also note that the facts presented raise the possibility that the ' 1.985-3(e)(3)(iii) anti-abuse rule may be applicable. Application of this rule, however, would require additional factual development.

ISSUE 2.

Section 1.985-3(e)(3)(vii)(B) (Step 7B) provides that generally the amount of DASTM gain on interest-bearing liabilities that generate related person interest expense is allocated in the same manner that the related person interest expense of that debt is required to be allocated under the rules of section 954(b)(5) and ' 1.904-5(c)(2)

Under ' 1.904-5(c)(2), related person interest income is treated as income in a separate category to the extent it is allocable to income of the payor controlled foreign corporation in that category. Under section 954(b)(5), related party interest expense is allocated to and reduces (but not below zero) the payor=s passive foreign personal holding company income (FPHCI). Accordingly, DASTM gain on related party liabilities should be allocated to the passive FPHCI.

In normal circumstances, a DASTM gain on a liability should not exceed interest expense produced by that liability. Accordingly, we suggest that further factual development be considered to determine if the amount of interest charged was determined at arm=s length consistent with section 482.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

With respect to issue 2, the interpretation set forth above is consistent with the literal language of the regulations. However, the regulation was drafted under the assumption that a DASTM gain would not exceed interest expense since an arm=s length transaction would require a real rate of return. Thus, ' 1.985-3(e)(3)(vii) instructs taxpayers to allocate gain by using a method used to allocate interest. The method used to allocate interest instructs taxpayers to allocate interest and reduce certain items of income, but not below zero. When allocating an item of gross income, it is not possible to allocate in the same manner since an item of income cannot reduce another item of income. Without more specific guidance regarding how to allocate the gain, P may argue that regulations allocating interest expense cannot be used to allocate income and therefore any reasonable method should be accepted.

If you have any further questions, please call the branch telephone number.

JEFFREY L. DORFMAN
Branch Chief