Reg. 1.904-4(f)(4)(ii), Example 2

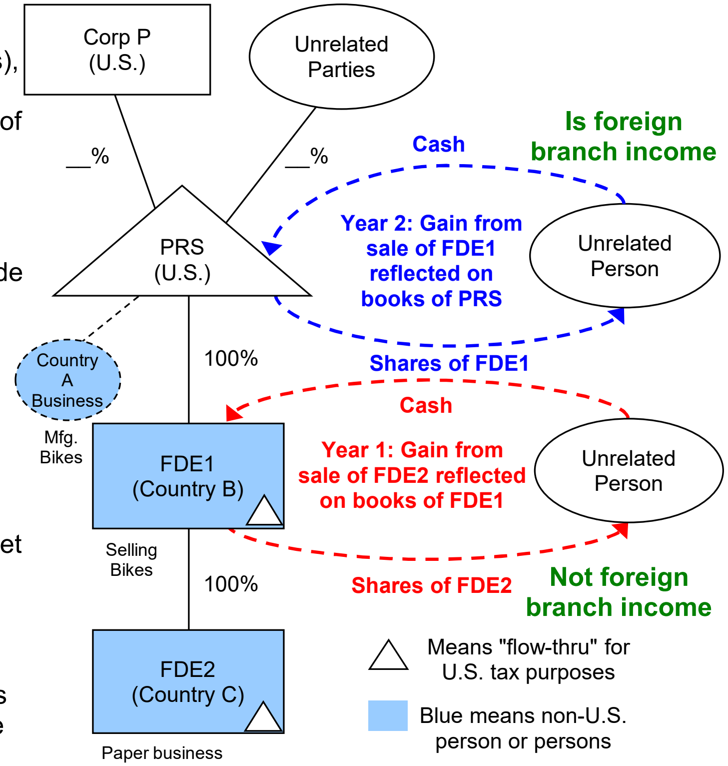
Sales of Foreign Branches

P, a domestic corporation, is a partner in PRS, a domestic partnership. All other partners in PRS are unrelated to P. PRS conducts activities solely in Country A (the Country A Business), and those activities constitute a trade or business outside the United States within the meaning of Reg. 1.904-4(f)(3)(vii)(B). PRS reflects items of income, gain, loss, and expense of the Country A Business on the books and records of PRS's home office. PRS is in the business of manufacturing bicycles.

PRS owns FDE1, a disregarded entity organized in Country B. FDE1 conducts activities in Country B (the Country B Business), and those activities constitute a trade or business outside the United States within the meaning of Reg. 1.904-4(f)(3)(vii)(B). FDE1 maintains a set of books and records that are separate from those of PRS, and the separate set of books and records reflects items of income, gain, loss, and expense with respect to the Country B Business. FDE1 is in the business of selling bicycles manufactured by PRS.

FDE1 owns FDE2, a disregarded entity organized in Country C. FDE2 conducts activities in Country C (the Country C Business), and those activities constitute a trade or business outside the United States within the meaning of Reg. 1.904-4(f)(3)(vii)(B). FDE2 maintains a set of books and records that are separate from those of PRS and FDE1, and the separate set of books and records reflects items of income, gain, loss, and expense with respect to the Country C Business. FDE2's paper business is not related to FDE1's bicycle sales business, and FDE1 does not hold its interest in FDE2 in the ordinary course of its trade or business.

In Year 1, FDE1 sells FDE2 to an unrelated person, recording gain from the sale on its books and records. In Year 2, PRS sells FDE1 to another unrelated person, recording gain from the sale on its books and records. In each year, PRS allocates a portion of the gain to P.



<u>Sale of FDE2</u>. Under Reg. 1.904-4(f)(1)(i)(B), P's distributive share of gain recognized by PRS in connection with the sales of FDE1 and FDE2 constitutes foreign branch category income if it is attributable to a foreign branch held by PRS directly or indirectly through one or more disregarded entities. PRS's gross income from the Year 1 sale of FDE2 is reflected on the separate set of books and records maintained with respect to the Country B Business (a foreign branch) operated by FDE1. Therefore, absent an exception, under Reg. 1.904-4(f)(2)(i) PRS's gross income from the sale of FDE2 would be attributable to the Country B Business, and would constitute foreign branch category income. However, under Reg. 1.904-4(f)(2)(iv), gross income attributable to the Country B Business does not include gain from the sale or exchange of an interest in FDE2, a disregarded entity, unless the interest in FDE2 is held by the Country B Business in the ordinary course of its active trade or business (within the meaning of Reg. 1.904-4(f)(2)(iv)(B)). In this case, the Country B Business does not hold FDE2 in the ordinary course of its active trade or business within the meaning of Reg. 1.904-4(f)(2)(iv)(B). As a result, P's distributive share of gain from the sale of FDE2 is not attributable to a foreign branch, and is not foreign branch category income.

<u>Sale of FDE1</u>. The analysis of PRS's sale of FDE1 in Year 2 is the same as the analysis for the sale of FDE2, except that PRS, through its Country A Business, holds FDE1 in the ordinary course of its active trade or business within the meaning of Reg. 1.904-4(f)(2)(iv)(B) because the Country A Business engages in a trade or business that is related to the trade or business of FDE1. Therefore, P's distributive share of gain from the sale of FDE1 is attributable to a foreign branch, and is foreign branch category income.