P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of Reg. 1.904-4(f)(3)(vii). FDE’s functional currency is the U.S. dollar. P holds Asset A, a non-depreciable asset, with an adjusted basis of $200x. In Year 1, P sells Asset A, which will be used in FDE’s manufacturing business, to FDE for $500x. FDE makes no other disregarded payments with respect to Asset A. No adjustments described in section 1016(a) apply with respect to Asset A while FDE holds Asset A. In Year 3, FDE sells Asset A to a third party for $600x and reflects $400x of gross income on its separate set of books and records (that is, $600x amount realized less Asset A’s $200x adjusted basis). Under sections 865(e)(1) and 904(d)(2)(B)(i), the income arising from the sale of Asset A is foreign source income that is not treated as passive category income. Asset A is not inventory property. Absent the application of Reg. 1.904-4(f)(2)(vi), the entire $400x of gross income earned by P by reason of FDE’s sale of Asset A would be attributable to FDE and be treated as foreign branch category income.

(1) Disregarded basis determinations. If regarded, the $500x payment from FDE to P would result in FDE holding Asset A with a basis of $500x under section 1012. Accordingly, the tentative disregarded basis (within the meaning of Reg. 1.904-4(f)(3)(x)) with respect to Asset A is $500x. Because there are no adjustments described in section 1016 with respect to Asset A (including any adjustments resulting from any disregarded payments made with respect to the transferred property), the adjusted disregarded basis (within the meaning of Reg. 1.904-4(f)(3)(i)) with respect to Asset A is $500x.

(2) Adjusted disregarded gain. Under Reg. 1.904-4(f)(3)(ii), the adjusted disregarded gain with respect to Asset A is $300x, which is equal to the lesser of $300x (FDE’s adjusted disregarded basis in Asset A ($500x) less the adjusted basis of Asset A at the time that Asset A was transferred to FDE ($200x)) and $400x (the gain (if any) attributable to the regarded sale or exchange of Asset A).

(3) Attribution of gross income. Under Reg. 1.904-4(f)(2)(vi)(A), the gross income attributable to FDE ($400x) is adjusted downward to the extent that the $500x disregarded payment from FDE to P is allocable to gross income of FDE that is reflected on FDE’s separate set of books and records. Under Reg. 1.904-4(f)(2)(vi)(B)(ii), the $500x payment from FDE to P is allocable to gross income attributable to FDE to the extent of FDE’s adjusted disregarded gain ($300x) with respect to Asset A. The source and separate category of the gross income of FDE to which the payment is allocable is proportionate to the source and separate category of the gain recognized by FDE with respect to Asset A. Accordingly, $300x of the payment is allocable to foreign source income that would be foreign branch category income. Thus, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(3), foreign source gross income attributable to P is adjusted upward by $300x (increasing foreign source general category income by $300x) and foreign source gross income attributable to FDE is adjusted downward by $300x (decreasing foreign source foreign branch category income by $300x) in Year 3.