Internal Revenue Service

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LEGEND

Taxpayer =

Corporation A =

Corporation C =

Partnership B =

Industry M =

Country A =
Country B =

Year 1 =
Year 2 =

x percent =
y percent =

Dear :

This is in response to a letter dated June 7, 2007, submitted on behalf of Taxpayer by its authorized representative, requesting a ruling as to the Federal income tax consequences of a sale of government-allocated emissions allowances. The ruling contained in this letter is based upon information and representations submitted by Taxpayer, and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of this request for ruling, such material is subject to verification upon examination. The information submitted in the request is substantially as set forth below.

FACTS

Taxpayer indirectly owns through a chain of foreign subsidiaries approximately *x* percent of the vote and value of Corporation A. The remaining interest is owned by parties unrelated to Taxpayer. Corporation A, which is organized in Country A, engages in Industry M in Country A.

Taxpayer indirectly owns 100 percent of the vote and value of Partnership B, a Country B entity that is treated as a controlled foreign partnership under Internal Revenue Code (Code) section 6038(e). Partnership B is *y* percent directly owned by Corporation C, a controlled foreign corporation (CFC) of Taxpayer, organized in Country A. The remaining interest of Partnership B is directly owned by a domestic subsidiary corporation of Taxpayer. Partnership B engages in Industry M, as well as other industries, in Country B.

Both Country A and Country B are member states in the European Union (E.U.). The E.U. has developed the Emissions Trading Scheme (ETS) to regulate the emissions of carbon dioxide (CO_2) or its equivalent within certain industries, including Industry M. Beginning on January 1, 2008, the E.U. ETS will be expanded to include regulation of 5 other greenhouse gases. Corporation A and Partnership B are subject to the provisions of the ETS.

Under the ETS, member states are permitted to emit specified amounts, measured in units, of the regulated greenhouse gases. The emissions capacity of each member state is represented by an allocation of allowances to that member state. Each member state is required to prepare a plan for distributing its allocation of allowances among all businesses in the regulated industries that operate within its borders. Corporation A and Partnership B received CO_2 allowances from Country A and Country B, respectively, in Year 1 and Year 2. A business must surrender its allocated allowances for any year to the relevant authority in amounts equal to its emissions for the year. To the extent the measured emissions of a business exceed its allowances, a fine is imposed. However, to the extent a business has excess allowances, it may sell any surplus to another person. Corporation A and Partnership B had surplus allowances in Year 1 and Year 2, which were sold to unrelated purchasers.

Taxpayer represents that CO_2 allowances are traded over the counter and on exchanges such as the European Climate Exchange, the European Energy Exchange and Nordpool.

RULING REQUESTED

Gain from the sale of surplus CO_2 allowances by Corporation A and Partnership B does not constitute foreign personal holding company income (FPHCI) within the meaning of Code section 954(c).

LAW

Code section 951(a) requires a United States shareholder of a CFC to include in gross income its pro rata share of the CFC's subpart F income for the taxable year.

Code section 951(b) defines the term "United States shareholder" to mean any United States person (as defined in Code section 957(c)) who owns (within the meaning of Code section 958) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

Code section 957(a) defines a CFC to mean any foreign corporation if more than 50 percent of the total combined voting power of all classes of its stock or more than 50 percent of the total value of its stock is owned by United States shareholders on any day during the taxable year of such foreign corporation.

Code section 952(a) defines subpart F income to include, among other things, foreign base company income.

Treas. Reg. § 1.952-1(g)(1) provides that a CFC's distributive share of any item of income of a partnership is income that falls within a category of subpart F income, as defined in Code section 952(a), to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly.

Code section 954(a) defines four categories of foreign base company income, including FPHCI.

Code section 954(c)(1)(C) provides, in part, that FPHCI includes the excess of gains over losses from transactions in any commodity.

Treas. Reg. § 1.954-2(f)(2)(i) defines the term "commodity", for purposes of this section, to include tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.

Code section 954(c)(1)(B)(iii) provides that FPHCI includes the excess of gains over losses from the sale of property which does not give rise to any income.

Treas. Reg. § 1.954-2(e)(3) provides that property that does not give rise to income includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options. Treas. Reg. § 1.954-2(e)(3)(iv) provides that property that does not give rise to income excludes intangible property (as defined in Code section 936(h)(3)(B)) to the extent used or held for use in the CFC's trade or business.

Treas. Reg. § 1.954-2(a)(5) provides special rules for calculating FPHCI applicable to distributive shares of partnership income. Treas. Reg. § 1.954-2(a)(5)(ii)(A) provides that the exclusion provided by Treas. Reg. § 1.954-2(e)(3)(iv) shall apply only if such exception would have applied to exclude the income from FPHCI if the CFC had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the CFC or any other person.

Code sections 936(h)(3)(B)(iv) and (vi) include in the definition of intangible property any franchise, license, or contract, or any similar item, which has substantial value independent of the services of any individual.

Treas. Reg. § 1.954-2(a)(2) provides coordination rules for overlapping categories under the FPHCI provisions. Under those rules, gain or loss from commodities transactions under Code section 954(c)(1)(C) take priority over gain or loss from certain property transactions under Code section 954(c)(1)(B).

ANALYSIS

For Federal income tax purposes, Corporation A is a CFC and Taxpayer is a U.S. shareholder of Corporation A. Thus, Taxpayer must include in gross income its pro rata share of Corporation A's subpart F income for the taxable year.

Pursuant to Treas. Reg. § 1.952-1(g)(1), for purposes of characterizing Corporation C's distributive share of income from Partnership B, the distributive share is treated as income that falls within a category of subpart F income to the extent the income would have been income in such category if Corporation C had received the income itself.

Taxpayer argues that CO_2 allowances should be viewed as commodities for purposes of Code section 954(c)(1)(C). The Service is currently studying this question but, solely for purposes of this letter ruling, believes it is appropriate at this point to analyze the CO_2 allowances as property that does not give rise to income within the meaning of Code section 954(c)(1)(B)(iii). No inference is intended as to whether CO_2 allowances are properly considered commodities for purposes of Code section 954 or any other section of the Code.

Taxpayer also argues that the allowances are property that does not give rise to income within the meaning of Code section 954(c)(1)(B)(iii). Therefore, in the absence of an exception, gain from the sale of allowances should be considered subpart F income includible in the gross income of Taxpayer.

Treas. Reg. § 1.954-2(e)(3)(iv) provides that intangible property (as defined in Code section 936(h)(3)(B)) is excluded from FPHCI to the extent used or held for use in the CFC's trade or business. Under Treas. Reg. § 1.954-2(a)(5)(ii)(A), the exception provided by Treas. Reg. § 1.954-2(e)(3)(iv) is applied to CFC partners by taking into account only the activities of the partnership. Code section 936(h)(3)(B) defines intangible property to include a franchise, license or contract, or similar item, that has substantial value independent of the services of any individual.

In this case, possession of CO_2 allowances is necessary to operate in Industry M. Emissions units per member state are decided by a governing authority and reflected in an allocation of allowances to that member state. The allowances are distributed by each member state to businesses operating in the regulated industries within its borders.

Because each allowance permits the holder to engage in a business activity otherwise unlawful, without penalty, the allocation of an allowance by a member state is the granting of an intangible property right to each business to emit CO_2 to a set limit. The value of the allowance is independent of the performance of services by any individual. Thus, for purposes of Code section 954(c)(1)(B), the allowances are intangible property within the meaning of Code section 936(h)(3)(B).

However, to qualify for the exclusion of Treas. Reg. § 1.954-1(e)(3)(iv), the intangible property of Corporation A and Partnership B must be used or held for use in Corporation A and Partnership B's trade or business. Based on the facts presented, Corporation A and Partnership B held the CO_2 allowances to offset emissions resulting from the operation of their businesses in Industry M. Thus, Corporation A and Partnership B held the emissions allowances for use in their trade or business. Therefore, the allowances are intangible property held for use in a trade or business within the meaning of Treas. Reg. § 1.954-2(e)(3)(iv) and gain from their sale is properly excluded from the definition of FPHCI found in Code section 954(c)(1)(B)(iii) by Corporation A and Corporation C.

RULING

Gain from the sale of surplus CO^2 allowances by Corporation A and Partnership B does not constitute foreign personal holding company income (FPHCI) within the meaning of Code section 954(c) to Corporation A or Corporation C.

This private letter ruling is directed only to the taxpayer who requested it. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter ruling must be attached to any federal income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's representative.

Sincerely,

Phyllis E. Marcus
Chief, Branch 2
(International)