



TaxNewsFlash

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U.S. Tax Court: Section 904(f)(3)(A) does not prevent recognition of gain in excess of overall foreign loss account or recharacterize such gain as foreign source income

The U.S. Tax Court today held that section 904(f)(3)(A) did not apply to prevent the taxpayer's recognition of approximately \$2.8 billion in gain (the amount of its gain in excess of its overall foreign loss (OFL) account) upon its sale of controlled foreign corporation (CFC) stock or to recharacterize such gain as foreign source income such that the taxpayer could claim more than \$240 million in foreign tax credits.

The case is: *Liberty Global Inc. v. Commissioner*, 161 T.C. No. 10 (November 8, 2023). Read text of the Tax Court's [opinion](#) [PDF 259 KB]

Summary

At the beginning of 2010, the taxpayer had an OFL account balance of approximately \$474 million. That year, the taxpayer sold all its stock in a CFC, realizing gain of more than \$3.25 billion. On its 2010 return, the taxpayer reported approximately \$438 million of the gain as dividend income pursuant to section 1248 and approximately \$2.8 billion as foreign source income, taking the view that Treas. Reg. § 1.904(f)-2(d)(1) required this result. The increased foreign source income allowed the taxpayer to claim foreign tax credits of more than \$240 million for the year.

The IRS determined that the taxpayer overstated its foreign source income for the year and consequently overstated its foreign tax credit, and the taxpayer petitioned the Tax Court for redetermination of the resulting assessed deficiency.

The parties agreed that section 904(f)(3) applied to the taxpayer's sale of CFC stock and that section 904(f)(3)(A) recaptured the taxpayer's OFL through the recognition of gain in an amount equal to the taxpayer's OFL (\$474 million) and recharacterized that amount as foreign source income. But they disagreed regarding the implications of section 904(f)(3) for the taxpayer's gain beyond the amount needed to accomplish its OFL recapture.

The taxpayer's first argument was that section 904(f)(3)(A), when applicable, is the only mechanism for recognizing gain from the disposition of CFC stock, overriding all other recognition provisions in chapter

1 of the Code. The taxpayer claimed that as a result, it was not required to recognize any gain that exceeded what was necessary to recapture its OFL balance.

The taxpayer's alternative argument was that if one concludes that section 903(f)(3)(A) is ambiguous, and thus the taxpayer must recognize gain in excess of the amount required to capture its OFL balance, Treas. Reg. § 1.904(f)-2(d)(1) requires treating such gain as foreign source income.

The IRS's position was that section 904(f)(3)(A) does not govern the treatment of the taxpayer's remaining \$2.8 billion in gain (which is instead subject to the rules of sections 865, 1001, and 1248) and that section 904(f)(3)(A) is not ambiguous and Treas. Reg. § 1.904(f)-2(d)(1) does not require that such gain be recharacterized as foreign source.

The Tax Court agreed with the IRS and held that section 904(f)(3)(A) speaks only to the gain necessary to recapture the OFL, and no more, and does not override any recognition provisions under chapter 1 of the Code. The court further held that section 904(f)(3)(A) is not ambiguous and neither section 904(f)(3)(A) nor Treas. Reg. § 1.904(f)-2(d)(1) recharacterizes as foreign source gain in excess of that necessary to recapture the OFL.

The foreign tax credits claimed by the taxpayer were thus disallowed, but the taxpayer was permitted to deduct its foreign taxes under section 164(a)(3).

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