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subject: Depositary Receipts Programs

This memorandum responds to your August 26, 2010, request for Generic Legal Advice.

ISSUES

1. Are payments by a domestic depositary institution to a foreign corporation for expenses the corporation incurs to institute a sponsored American Depositary Receipts program includible in the gross income of the corporation?

2. Are the payments to the foreign corporation subject to withholding under §1442 of the Internal Revenue Code?[1]

CONCLUSIONS

1. Payments by a domestic depositary institution to a foreign corporation for expenses the corporation incurs to institute a sponsored American Depositary Receipts program are includible in the gross income of the corporation.

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[1] Unless otherwise indicated, all reference to sections of the Code are to sections of the Internal Revenue Code of 1986, as amended.

2. The payments to the foreign corporation are subject to withholding under §1442 of the Code.

FACTS

Description of American Depositary Receipt Programs

Corporations (Issuers) use Depositary Receipts (DR) programs to make their stock more accessible to investors in foreign markets. DR programs that make stock of foreign Issuers available in domestic markets are known as “American Depositary Receipt” (ADR) programs.

In an ADR program, an Issuer’s stock is placed with, and maintained and controlled by, a Depositary Institution (DI), which is a domestic financial institution. The DI then offers interests in the Issuer’s stock in the form of ADRs to investors in domestic markets. ADRs are priced in U.S. dollars, and the DI makes dividend equivalent payments in U.S. dollars to the investors based on dividends paid in foreign currency by the Issuer to the DI. U.S. investors can also trade ADRs like shares of domestic companies on U.S. exchanges and over-the-counter (OTC) markets. The ADRs help to meet the needs of American investors that want to invest easily in foreign companies, without the inconveniences of cross-border or cross-currency transactions.

An ADR program may exist in two forms: sponsored and unsponsored. In an unsponsored ADR program, the Issuer does not agree to use an exclusive DI; any DI can acquire the Issuers’ stock and offer ADRs to U.S. investors. In a sponsored ADR program, the Issuer registers with the Securities and Exchange Commission (SEC) and chooses an exclusive DI. This memorandum pertains solely to payments to Issuers in sponsored programs.

Holders of sponsored ADRs (investors) have all the rights of most stockholders, including the right to receive reports, vote their shares, and receive dividends. If an investor relinquishes its ADR, the ADR is deemed “cancelled.” The cancelled ADR is returned to the DI, which then either returns the stock to the Issuer or sells it to another investor.

A DI receives compensation from multiple sources. Investors are charged for various services in administering the ADR program, including issuance fees charged for issuing the ADR, dividend fees, fees passed on from corporate actions, and cancellation fees. A DI also incurs its own expenses with third parties for issuing the ADRs, including listing and SEC fees, legal and accounting fees, marketing fees, and proxy and reporting fees. These fees are generally passed on to the investors in the form of investor fees.

Payment Arrangements

The Issuer incurs expenses to institute an ADR program. As an inducement to grant an exclusive arrangement for a sponsored ADR program, it is common for a DI to offer to pay a portion of the expenses the Issuer will incur in setting up the program. The terms of this arrangement are set forth in a contract between the DI and the Issuer. The contract also describes the ADR program, the role of the DI, and the fees that the DI will charge the investors.

The expenses of the Issuer typically paid by the DI under these arrangements include legal fees, accounting fees, SEC registration costs, marketing expenses, expenses for participating in investor conventions, costs for acquiring and maintaining electronic communications systems, exchange and listing fees, filing fees, underwriting fees, mailing and printing costs in connection with sending out financial reports, annual reports, proxy mailings, and other administrative costs.[2]

Normally, the Issuer must seek payments from the DI within a specified time. Payments are usually made after the Issuer presents acceptable documentation substantiating payment by the Issuer of ADR program-related fees or expenses. If the Issuer does not incur or does not timely submit its proof of expenditures, the Issuer will not receive any payments from the DI. The DI may make payments on behalf of the Issuer to third party vendors (usually to exchanges, law firms, investment banks and investor relations firms), or it may make payments directly to the Issuer.

The expenses of the Issuer that the DI agrees to pay are typically subject to a cap, either a fixed dollar amount or an amount calculated by reference to the size of the ADR program. Also, the expenses must be of the kind that the Issuer would not have incurred but for the DR program. The Issuer's operating costs, such as salary or overhead expenses, are not paid by the DI.

APPLICABLE LAW and ANALYSIS

ISSUE 1: <u>Includibility of ADR Program Payments in Gross Income</u>

Section 61 of the Code generally provides that gross income means all income from whatever source derived, including income from discharge of indebtedness. The term "income" is broadly defined as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S.426, 431 (1955).

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[2] A DI normally charges fees to the Issuer for setting up and administering of ADR program. In some instances, the DI will waive some of its fees for setting up the DR program as an inducement for an exclusive (sponsored) arrangement. However, the tax treatment of these waivers is not at issue in this memorandum.

It is well established that the payment of the expenses of a taxpayer by another is includible in the taxpayer's gross income. *See, e.g., Old Colony Trust v. Commissioner,* 279 U.S. 716 (1929) (payment of employee's income taxes by the employer made in consideration of employee's services constituted additional taxable income of employee); *Silverman v. Commissioner,* 253 F.2d 849 (8th Cir. 1958) (payments to an employee for wife's travel expenses on business trip to Europe includible in gross income of employee). Moreover, the payments are includible in the taxpayer's gross income regardless of whether they are made directly to the taxpayer or to a third party on the taxpayer's behalf. *See Old Colony* at 729, which held it "immaterial that the taxes were paid over directly to the government. The discharge by a third person of an obligation [of the taxpayer] is equivalent to receipt by the [taxpayer]." *See also Vasquez v. Commissioner,* T.C.M. 1997-78 (repayment of student loans by employer includable in student's gross income).

In contrast to situations in which a taxpayer has gross income when someone pays its expenses, a taxpayer does not have gross income when it pays the expenses of another person and receives a reimbursement of its payments. Expenditures of this nature are analogous to loans in which the taxpayer is the lender and the party for whom the expense is paid (and who reimburses the taxpayer for paying the expense) is a borrower. In these situations, the payments are not taxable events any more than a loan, or the corresponding repayment of the principal of a loan, are taxable events. These payments are not accessions to the wealth of the taxpayer and thus not includible in the taxpayer's gross income. *See, e.g.,* Rev. Rul. 67-407, 1967-2 C.B. 59 (payments of expenses incurred by taxpayers for living expenses while facilitating the reimbursing party's research project held not includible in the taxpayers' income because taxpayers were required to incur the expenses as part of the research project and would not have otherwise incurred the expenses); Rev. Rul. 77-280, 1977-2 C.B. 14, *modified as to unrelated issues by* Rev. Rul. 84-61, 1984-1 C.B. 39 (payments to foster parents by child-placement agency not includible except to the extent that the payments exceed the expenses incurred by the foster parents in supporting the child); and Rev. Rul. 57-60, 1957-1 C.B. 25, *clarified by* Rev. Rul. 60-280, 1960-2 C.B. 12 (payments to parents by a school board for transporting children to school where no school bus is available is not includible in gross income of parents because the school board is obligated to provide transportation to school).

In addition, when a person pays the expenses of another primarily to advance the business interest of the person making the payments, the payments are not includible in the gross income of the recipient, notwithstanding any incidental or indirect economic benefit to the recipient. *See, e.g., United States v. Gotcher*, 401 F.2d 118 (5th Cir. 1968) (expenses paid for auto dealer by European manufacturer for trip to Germany to tour facilities as required by manufacturer held not includible in auto dealer's gross income because the costs for the taxpayer-dealer's trip were incurred primarily for the payor-manufacturer's benefit.) *See also* Rev. Rul. 63-77, 1963-1 C.B. 177 (reimbursement to individual of costs incurred to attend interview by prospective employer not includable in gross income because the costs are those of the prospective employer); and Rev. Rul. 80-348, 1980-2 C.B. 31 (payments to elected delegates by an international labor union for travel expenses to attend its annual convention held not includible in delegates' gross income). In all three instances, the expenditures were primarily for the benefit of the payor. In *Gotcher*, the expenditures were made to ensure that the dealer was well-informed with firsthand knowledge of the nature, extent and soundness of the manufacturer's product, processes, industrial base and organization. Similarly, in the revenue rulings, the needs of the payor, not the payee, motivated the expenditures (as in Rev. Rul. 63-77, where the expenditures allowed greater access to the best available job candidates, while in Rev. Rul. 80-348, the expenditures were presumably due to the labor union's need for its delegates to attend the labor convention).

In the present case, however, the expenses paid by the DI are those of the Issuer, as indicated by at least four factors: (1) the payments are for expenses any issuer would expect to incur to sell its stock in the United States; (2) the DI does not have a pre-existing obligation to incur these, the source of its obligation being solely by virtue of its agreement with the issuer; (3) the Issuer has discretion over which accounting firm, law firm, vendor, etc., to use in instituting its DR program when it incurs the expenses; and (4) the DI does not pay all of the expenses necessary to set up the ADR program, but only up to an agreed or capped amount, leaving the balance payable by the Issuer. Moreover, the DI has not paid any direct consideration for the exclusive right to serve as the depositary for the Issuer's ADR program, thus suggesting that the DI's payments of the Issuer's expenses are intended to compensate the Issuer for its agreement to deal exclusively with the DI. Finally, the DI's payments to, or on behalf of, the Issuer are primarily and directly for the Issuer's benefit in instituting the ADR program. They are not primarily for the DI's benefit. Thus, the present case is distinguishable from the cases in which the payments at issue are reimbursements of expenses incurred for the primary benefit of the reimbursing party. Consequently, the payments by the DI to the Issuer, or to third parties on behalf of the Issuer, of the Issuer's expenses incurred to institute an ADR program are gross income to the Issuer.

Of some relevance to the issue of whether a taxpayer has gross income for a payment of its expenses are the cases dealing with whether reimbursed expenses are deductible by the payor of the expenses. For the same reasons that a taxpayer does not have gross income when it pays the expenses of another person and receives a reimbursement of its payments, the taxpayer should not be allowed a deduction for the payment of another's expenses if the other person has agreed to reimburse the taxpayer for its payments. Thus, in

Canello v. Commissioner, 53 T.C. 217 (1969), payments made by an attorney for his client's litigation expenses under an agreement that the attorney was to be reimbursed for the expenses were held to be not deductible by the attorney. *Compare Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), in which the court held that the litigation costs paid under a gross fee contract, with no provision for client reimbursement from litigation proceeds, were deductible by the attorney.

In addition, *Patchen v. Commissioner*, 27 T.C. 592, 600 (1956), *rev'd in part on other issues* at 258 F.2d 544 (5th Cir. 1958) and *Flower v. Commissioner*, 61 T.C. 140 (1973), involve the nondeductibility of reimbursed expenses. In these two cases the courts stated that, where a taxpayer makes expenditures under an agreement that he will be reimbursed, the expenditures are in the nature of loans or advancements and not deductible.

In the present case, some may argue that, under *Patchen* and *Flower,* the Issuer would not be entitled to a deduction for its expenses to the extent it will be reimbursed by the DI for the expenses and, correspondingly, should not have gross income when DI pays the Issuer for the expenses. However, as noted above, the expenses at issue are the Issuer's expenses, not the DI's. Therefore, the Issuer should not be denied a deduction for the expenses merely because the DI has agreed to pay a portion of them. More importantly, because *Patchen* and *Flower* address only the deductibility of a reimbursed expense, neither is determinative of the question of whether the payment of the Issuer's expenses by the DI is gross income to the Issuer.

Accordingly, payments by the DI to the Issuer (or to third parties on the Issuer's behalf) of expenses incurred in instituting ADR programs, as described in the facts, are includible in the gross income of the Issuer under § 61 of the Code.

ISSUE 2: <u>Applicability of § 1442 Withholding to ADR Program Payments</u>

Section 1441 of the Code requires any person making a payment of U.S. source fixed or determinable annual or periodical income (FDAP) to a *nonresident alien* to withhold from the payment a tax equal to 30 percent, unless such tax rate is reduced by a provision of the Code or a treaty or the income is effectively connected with a U.S. trade or business. Section 1442 of the Code provides that payments to *foreign corporations* are subject to withholding taxes in the manner provided under § 1441. FDAP includes all amounts included in gross income under section 61 other than gains from the sale of property. *See* § 1.1441-2(b) of the Income Tax Regulations.

The ADR program payments are an inducement for the Issuer to enter into a sponsored ADR program with the DI. Specifically, the DI agrees to pay the Issuer's ADR program expenses to obtain the exclusive right to be the sole distributor of ADRs with respect to stock in the Issuer. The payments are strictly consideration for the guarantee of exclusive distribution rights; DIs do not make ADR program payments to Issuers in unsponsored programs. In a sponsored ADR program, the DI obtains, for a period of time, the right to profit from the distribution of shares in the Issuer in the U.S. market without competition from other DIs. Inherent in this right is also the right to benefit from the use of the Issuer's trade name and reputation in marketing the ADRs. These rights represent an interest in intangible property. *See, e.g.,* § 197 of the Code (including within the definition of amortizable intangible property goodwill, any franchise, trade-mark or trade name, any customer based intangible such as market share or the value resulting from the future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.)

In tax law, a payment made for the right to use an intangible property right is a royalty. *See Jones v. Commissioner*, 76 T.C.M. (CCH) 597 (1998). Under § 861(a)(4) of the Code, royalties for the privilege of using "patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property" in the United States constitute U.S. source income. The rights obtained from the Issuer under a sponsored ADR program are similar to a franchise arrangement for the distribution of a product within a given marketplace. *See, e.g.,* § 1253(b)(1) of the Code (defining a franchise for purposes of this section as an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services or facilities, within a specified area). Due to the similarity of the DI's rights under a sponsored ADR program to the intangible property listed within § 861(a)(4), we conclude that the payments under the program should fall within "other like property" for purposes of § 861(a)(4). Thus, because the ADR program payments are made to obtain the exclusive right to distribute ADRs in the United States, the payments constitute income from sources within the United States.

Accordingly, the ADR program payments are U.S. source FDAP and are subject to the 30 percent withholding tax required under § 1442 of the Code, unless the Issuer is engaged in a trade or business in the United States or that amount is otherwise reduced by a treaty.

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