Part I – Rulings and Decisions Under the Internal Revenue Code of 1986

Credit for Certain Foreign Withholding Taxes

Notice 2005-90

PURPOSE

This Notice provides guidance regarding the application of section 901(l) of the Internal Revenue Code (Code). In particular, it addresses section 901(l)(1)(B), which disallows a foreign tax credit for certain withholding taxes on items of income or gain to the extent the recipient of the item is under an obligation to make related payments with respect to positions in substantially similar or related property. The Treasury Department and the Internal Revenue Service (IRS) expect to issue regulations that incorporate the guidance provided in this notice.

BACKGROUND

Section 832 of the American Jobs Creation Act of 2004 (P.L. 108-357) (the Act) added new subsection (l) to section 901 of the Code. Section 901(l) generally disallows a foreign tax credit for foreign withholding tax on any item of income (other than dividends) or gain with respect to property if (a) the recipient of the item has not held the property for more than 15 days (within a 31-day testing period), exclusive of periods during which the recipient is protected from risk of loss, or (b) the recipient is under an obligation (whether pursuant to a short sale or otherwise) to make related payments

with respect to positions in substantially similar or related property. Section 901(l)(3) provides that the Secretary may by regulation provide that section 901(l)(1) does not apply to property where such application is not necessary to carry out the purposes of section 901(l). Section 901(l) is effective for amounts that are paid or accrued after November 21, 2004, the date which is 30 days after the date of enactment of the Act. Section 901(l) provides a rule similar to section 901(k), enacted in 1997, which disallows a foreign tax credit for certain foreign taxes paid with respect to certain dividends.

DISCUSSION

The Treasury Department and the IRS remain concerned about transactions that involve inappropriate foreign tax credit results. In this regard, the Treasury Department and the IRS believe that the credit disallowance rules of section 901(l) are important tools in preventing transactions designed for tax purposes to separate foreign taxes from the related foreign income. The language of section 901(l) and its legislative history, however, make clear that the Treasury Department and the IRS are authorized to exercise regulatory authority to prevent application of the general rule of section 901(l) in appropriate cases.

The Treasury Department and the IRS have become aware of certain business arrangements involving computer software licensing in which application of the credit disallowance rules of section 901(l) is not necessary to carry out the purposes of section 901(l). Under a typical business arrangement, a domestic corporation (X) licenses rights to a computer program (the master license agreement) to another domestic corporation (Y) for use in computers and similar and related equipment that Y employs

in connection with its business or that it manufactures and markets to customers. Y conducts its business operations through various domestic and foreign subsidiaries, sublicensing rights to X's computer program to the subsidiaries as permitted under the terms and conditions of the master license agreement. X licenses the computer program to Y rather than directly to each of Y's subsidiaries because X wishes to centralize its customer relationship with Y and minimize administrative burdens, minimize its exposure to the credit risk and local risk of Y's foreign subsidiaries, and protect its rights in the computer program. Pursuant to the master license agreement, Y makes payments to X when (a) Y or Y's subsidiaries reproduce the licensed computer program on computers and other equipment used by Y or Y's subsidiaries or (b) Y or Y's subsidiaries reproduce and distribute X's computer program on computers and other equipment manufactured and marketed to customers by Y or Y's subsidiaries. Pursuant to the sublicense agreements, Y's subsidiaries make payments to Y when they reproduce X's computer program on computers and other equipment that they use or when they reproduce and distribute X's computer program on computers and other equipment that they manufacture and market to customers. Foreign gross-basis withholding taxes may be imposed with respect to the payments by Y's foreign subsidiaries to Y.

As noted, section 901(l) generally disallows a foreign tax credit for foreign withholding tax on any item of income (other than dividends) or gain with respect to property if the recipient is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or

related property, and section 901(l)(3) provides that the Secretary may by regulation provide that section 901(l)(1) does not apply to property where such application is not necessary to carry out the purposes of section 901(l).

Pursuant to section 901(l)(3), the Treasury Department and the IRS have determined that the application of section 901(l) to foreign withholding taxes imposed on payments in a back-to-back computer program licensing arrangement in the ordinary course of the licensor's and licensee's respective trades or businesses is not necessary to carry out the purposes of section 901(l). For this purpose, a "back-to-back computer program licensing arrangement" is a transaction or series of transactions in which (a) a domestic corporation (the master licensor) transfers a copyright right in a computer program or a copy of the computer program (as those terms are defined in Treas. Reg. §1.861-18(c) and (f)) to a domestic corporation (the head licensee), and (b) the head licensee transfers a copyright right in the computer program or a copy of the computer program to one or more of its affiliates, as permitted under the terms and conditions of the master license agreement, for use in computers and similar and related equipment manufactured and marketed by the affiliate (in the case of a transfer of a copyright right) or for the affiliate's own use (in the case of a transfer of a copy of the computer program). For this purpose, an affiliate is any member of the head licensee's affiliated group as defined in section 1504(a), except that foreign corporations and section 936 corporations meeting the ownership requirements of section 1504(a) are also included in the affiliated group.

For purposes of this notice, a back-to-back computer program licensing

arrangement will be in the ordinary course of the licensor's and licensee's respective trades or businesses if (1) the arrangement is consistent with normal business practices of the master licensor, independent of tax considerations, such as maintaining a centralized customer relationship with its licensee and minimizing administrative burdens and commercial risks; (2) the master licensor or one or more members of its affiliated group (as defined in section 1504(a)) is regularly engaged in the business of selling, leasing, or licensing computer programs; and (3) in the case of each transfer of a copyright right in the computer program or a copy of the computer program to an affiliate of the head licensee, where the payments with respect to such transfer are subject to foreign withholding taxes, the affiliate uses the copyright rights or the copy of the computer program in a trade or business within the meaning of Treas. Reg. §1.367(a)-2T(b)(2) and (b)(5).

Pursuant to section 901(l)(3), the Treasury Department and the IRS expect to issue regulations providing that section 901(l)(1)(B) will not apply to disallow a credit for foreign gross-basis withholding taxes imposed on income or gain with respect to back-to-back computer program licensing arrangements described in the preceding two paragraphs. In addition, the Treasury Department and the IRS are considering issuing regulations providing that section 901(l)(1)(B) generally will not apply to payments between members of the same consolidated group. The Treasury Department and the IRS also contemplate issuing regulations under section 901(k) and (l) addressing issues on which comments are solicited below.

EFFECTIVE DATE

The exception from the application of section 901(l)(1)(B) described in this notice is effective for amounts that are paid or accrued after November 21, 2004 (the effective date of section 901(l)). Until regulations incorporating the guidance set forth in this notice are issued, taxpayers may rely on the guidance contained in this notice.

REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS request comments concerning the exception to section 901(l)(1)(B) described in this notice and any additional issues that should be addressed by regulations. In particular, comments are requested on (a) whether the licensing exception should apply in the case of sublicenses to related parties that are not corporations (and which test of "relatedness" should apply), (b) the extent to which the licensing exception should apply if the master licensor or head licensee is a foreign corporation, (c) other types of licensing arrangements and types of property that should be covered by the licensing exception, (d) what restrictions should apply as part of the ordinary course of a trade or business requirement, and (e) other types of transactions that are not within the purposes of section 901(l) and the reasons for excluding such transactions from the application of section 901(l).

In addition, comments are requested on the definitions of "related payments" and "positions in substantially similar or related property" for purposes of section 901(k) and (l). In particular, comments are requested on the application of section 901(k) where the recipient of a dividend is obligated to make payments under an arrangement where such payments reflect not only the amount of the dividend but also other factors, such

as changes in the value of the dividend-paying stock, dividend performance or changes in the value of a portfolio of stocks, or obligations under a debt instrument, annuity, or insurance contract. Finally, comments are requested on how regulations should address the effect of hedging transactions (including hedges of risk with respect to interest rate or currency fluctuations and credit risk) on the holding period and related payment rules of section 901(k) and (l).

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Ginny Chung (Notice 2005-90), CC:INTL:3, Internal Revenue Service, 1111 Constitution Avenue, NW, IR-4555, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.comments@irscounsel.treas.gov. Comments will be available for public inspection and copying. For further information regarding this notice, contact Ms. Chung of the Office of Associate Chief Counsel (International) at (202)-622-3850 (not a toll-free call).