OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
August 22, 2000

Number: **200049010**
Release Date: 12/8/2000
CC:INTL:Br3
TL-N-303-00
UILC: 901.01-03

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NORTHERN CALIFORNIA DISTRICT
CC:WR:NCA:SF
Attn: MICHELLE D. KORBAS

FROM: Anne O'Connell Devereaux
Assistant to the Branch Chief CC:INTL:Br3

SUBJECT:

This Field Service Advice responds to your memorandum dated February 16, 2000, as supplemented on May 16, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND:

Taxpayer =
Sub =

ISSUE:

Whether the 11.75% surcharge imposed on the amount of Danish corporate income tax liability paid by Sub under the "traditional method" was a creditable tax for the years in issue under section 901.

CONCLUSION:

The 11.75% surcharge imposed on the corporate income tax liability paid by Sub under Denmark's "traditional method" was not creditable under section 901 for the years in issue because the surcharge is a similar obligation to interest and payment of such surcharge is not compulsory.[1]

FACTS:

Taxpayer is a U.S. software company with worldwide operations. During taxable years ending in 1993 through 1995, Taxpayer's wholly owned Sub, incorporated in Denmark, paid corporate income tax to Denmark pursuant to the traditional method. For taxable years ending in 1994 and 1995, Taxpayer claimed indirect foreign tax credits under sections 902 and 960 on its United States income tax return for those taxes paid by Sub to Denmark.

Companies incorporated in Denmark after January 1992 are required to pay their Danish corporate income tax under the on-account method. However, certain corporations incorporated prior to January 1992 may choose between the traditional method and the on-account method of paying their Danish corporate income tax liability.[2]

In Denmark, the corporate income tax rate is 34% of taxable income. Under the traditional method, corporations with tax years ending after March 31st through

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[1] Our conclusion herein is based upon an unofficial translation of a portion of the Danish tax law in question and widely published summaries describing the methods of paying tax under Danish law. The conclusion in this ruling is premised on the accuracy of that translation and those publications.

[2] To be eligible for the traditional method, the share capital of the corporation must exceed 200,000 DKK, and (from January 1998) the annual taxable income of the corporation cannot exceed DKK 10,000,000.

December 31st are required to pay Danish corporate income tax in November of the first full calendar year following the end of the tax year, and corporations with tax years ending on or after January 1st through March 31st are required to pay such tax in the first November following the end of the tax year. On the applicable due date, taxpayers are required to pay their tax liability plus a surcharge of 11.75% on any portion of the tax liability that remained unpaid in November preceding the due date. For example, for taxpayer's 1994 calendar tax year, it must pay its tax liability and 11.75% surcharge (calculated based on the unpaid tax liability as of November of 1994) in November of 1995. A company that is eligible to pay taxes according to the traditional method can elect to switch to the on-account tax payment method; once elected, the taxpayer must continue to pay taxes under the on-account method and may not revert to the traditional method.

Under the on-account method, corporations are required to make two estimated income tax payments equal in the aggregate to one-half of the company's average yearly tax liability for the last three years. Taxpayers must make the first payment in March of its tax year, except for tax years that end during March in which case taxpayers must make the first payment in the preceding March. The second payment must be made in November following the first payment; late payments are subject to interest imposed at a rate of 0.6% per month. Under the on-account method, taxpayers can, in addition to their required on-account payments, voluntarily prepay a portion or all of their tax liability. Taxpayers are subject to a surcharge of 11.75% on any portion of the tax liability that remains unpaid after the second on-account payment due in November. The remaining tax liability and the 11.75% surcharge are due in November following the second on-account payment. For example, for taxpayer's 1994 calendar tax year, taxpayer must make its first on-account payment during March of 1994, its second on-account payment during November of 1994, and any remaining tax payment, in addition to the 11.75% surcharge (calculated based on the unpaid tax liability as of November of 1994), by November of 1995.

All corporate taxpayers, whether they use the traditional method or the on-account method of paying their tax, are subject to interest in the amount of 0.6% per month on any tax liability that remains unpaid after the final November tax payment date.

LAW AND ANALYSIS:

Under section 902, a domestic corporation is treated as having paid foreign income taxes actually paid by a foreign corporation from which it receives dividends if the domestic corporation owns at least 10 percent of the foreign corporation's voting stock. Section 960 similarly provides for indirect foreign tax credits in connection with subpart F inclusions. Deemed paid taxes are creditable under sections 902

and 960 only if they meet the requirements of section 901 of the Code, which generally allows a credit for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States.

I. Penalty, Fine, Interest or Similar Obligation

A foreign levy is an income tax if and only if it is a tax, and if the predominant character of that tax is that of an income tax in the U.S. sense. Biddle v. Commissioner, 302 U.S. 572 (1938); Treas. Reg. § 1.901-2(a)(i), (ii). A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Treas. Reg. § 1.901-2(a)(2)(i). A "penalty, fine, interest, or similar obligation" is not a tax. Id. We interpret these words by reference to the meaning attributed to them under U.S. income tax principles.

A penalty is a charge imposed for misconduct or failure to comply with certain requirements of the tax law. See sections 6651, 6662, 6673. A fine is synonymous with a penalty. See section 162(f). Sub's election to pay its Danish tax liability under the traditional method resulted in the imposition of an 11.75% surcharge on its entire tax liability. The obligation to pay the 11.75% surcharge under the traditional method was not a consequence of misconduct or noncompliance. Sub's liability for the surcharge arose even though it was in full compliance with the requirements of Danish tax law. Accordingly, the 11.75% surcharge is not a penalty or a fine.

Interest is defined as "compensation for the use or forbearance of money." Deputy v. duPont, 308 U.S. 488 (1940). Sub elected to pay its Danish corporate income tax under the traditional method and thereby voluntarily incurred an additional charge of 11.75% on its tax liability. By choosing the traditional method, Sub gained the "use or forbearance" of money it otherwise would have been required to pay at an earlier date under the on-account method. Sub was able to defer payment of that portion of its tax liability for several months in exchange for agreeing to pay an additional charge of 11.75% on those deferred amounts.

The 11.75% surcharge may differ from what is typically understood by the term "interest" in some respects. The surcharge is not based on the time value of money since the amount of the surcharge is not associated with the passage of time. Taxpayers' liability for the 11.75% surcharge becomes fixed 12 months prior to the final due date, and the surcharge is based on the amount of tax liability remaining unpaid at that time. A taxpayer that elects to use the traditional method has several months before any amount of tax liability is due. Regardless of whether the taxpayer pays or does not pay its tax liability between that date and the final due date, the amount of the surcharge remains the same. However, the Danish government's adoption of an administratively convenient method of calculating this

interest-like charge by imposing a fixed percentage surcharge does not affect the fact that the 11.75% surcharge remains, in the most basic sense, a payment for the use or forbearance of money. Accordingly, the 11.75% surcharge is an obligation similar to interest and therefore not a tax. Treas. Reg. § 1.901-2(a)(2)(i). Taxpayer is not entitled to a foreign tax credit under section 901 for any portion of the 11.75% surcharge paid by Sub under the traditional method for the years in issue.

II. Compulsory Payment

A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Treas. Reg. § 1.901-2(a)(2)(i). Treasury Regulation § 1.901-2(e)(5) provides that a payment is not compulsory, and thus not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined under principles of U.S. law and not under principles of law of the foreign country. Id. An amount paid does not exceed the amount of foreign tax liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax. Id.

Corporations that pay their tax pursuant to the traditional method will be liable for an 11.75% surcharge on the tax liability that remains unpaid as of the November preceding taxpayer's tax payment due date. However, the surcharge is avoidable if the taxpayer voluntarily pays its tax liability prior to that date. Sub elected Denmark's traditional method of tax payment, thereby deferring payment of its tax liability and incurring the 11.75% surcharge on its deferred liability. By electing to use the traditional method and incur a surcharge of 11.75% on its tax liability, the taxpayer did not apply the substantive provisions of the Danish law in such a way as to reduce its reasonably expected tax liability. Therefore, Sub's payment of the 11.75% surcharge is not compulsory. Accordingly, Taxpayer is not entitled to a foreign tax credit under section 901 for any portion of the 11.75% surcharge payments made by Sub under Denmark's traditional method.

Treasury Regulation § 1.901-2(e)(5)(i) provides that "where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in payment in excess of the taxpayer's liability for foreign tax." This provision is not applicable to the issue herein. Sub opted to defer payment of its tax liability under the traditional method and thereby incurred liability for the 11.75% surcharge. Sub did not shift its tax liability to a different year, but incurred additional liability for the surcharge by altering the time of payment of its tax liability. Accordingly, by choosing to defer payment of its tax liability and

incurring the avoidable surcharge, taxpayer failed to take reasonable steps to reduce, over time, its liability under foreign law.

Treasury Regulation § 1.901-2(e)(5)(i) provides that a taxpayer is not required to alter: (1) its form of doing business; (2) its business conduct; or (3) the form of any business transaction, in order to reduce its liability under foreign law for tax. Under the facts of this case, in order for Sub to reduce its tax liability, it is not necessary for it to alter its form of doing business, its business conduct, or the form of its business transactions. In order for Sub to reduce its reasonably expected tax liability as required under Treas. Reg. § 1.901-2(e)(5), it must avoid imposition of the 11.75% surcharge by altering the timing by which it makes its corporate tax payments to Denmark, thereby paying its liability in full prior to when its liability for the surcharge becomes fixed. Requiring Sub to alter its method of paying its Danish tax liability in order to avoid the 11.75% surcharge does not entail altering any of the three above enumerated categories.

In conclusion, the 11.75% surcharge imposed pursuant to Denmark's traditional method of paying corporate income tax is not a creditable tax under section 901 for the tax years in issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted][3]

[3] [redacted]

[redacted]

Please call (202) 622-3850 if you have any further questions.

ANNE O'CONNELL DEVEREAUX
Assistant to the Branch Chief
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