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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Barbara A. Felker
Chief, CC:INTL:Br3

SUBJECT:

This Field Service Advice responds to your memorandum dated June 20, 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

USparent =

DRsub =
Fsub =
$A =
$B =
$C =
$D =
$E =
$F =
$G =
$H =
Date X =
Date Y =
Year 1 =

ISSUES

1. Are the dividends received on Date X and Date Y by DRsub from Fsub in the amounts of $C and $D, respectively, foreign oil and gas extraction income ("FOGEI") as defined in section 907(c) of the Internal Revenue Code?

2. Are the U.K. Advance Corporation Taxes ("ACT") paid by DRsub with respect to the distributions to USparent and surrendered to Fsub to be used to offset its U.K. mainstream corporate tax liability taxes on FOGEI?

3. Are the 5% withholding taxes imposed by the U.K. on the aggregate of the Date Y distribution and ACT refundable credit ("ACT refund") taxes on FOGEI?

CONCLUSIONS

1. The portion of the dividends received by DRsub from Fsub attributable to earnings and profits of Fsub that are FOGEI will be FOGEI to DRsub under section 907(c)(3) of the Code.

2. A proportionate share of the ACT paid by DRsub with respect to the distributions to USparent are taxes on FOGEI.

3. The 5% withholding taxes imposed by the U.K. on the aggregate of the Date Y distribution and ACT refund are taxes on FOGEI in the same proportion that FOGEI is of the total distribution.

FACTS

USparent owns 100% of DRsub which owns 100% of Fsub. Most of Fsub's earnings and profits were generated from foreign oil and gas extraction activities that result in FOGEI as defined in section 907(c)(1) of the Code. DRsub is a holding company and is not directly engaged in oil and gas activities. DRsub is a dual resident of the U.S. and the U.K. Fsub is a U.K. corporation.

On Date X, Fsub distributed $A to DRsub which distributed that amount to USparent on the same day. The next day USparent returned the $A, plus an additional $C, to DRsub. DRsub paid $B, which is less than $A in the amount of $C, to Fsub in installments over the next two months. In return for the $B, Fsub distributed "convertible loan stock" to DRsub.

On Date Y, Fsub distributed $D to DRsub which distributed that amount to USparent on the same day.

With regard to the Date X and Date Y distributions, DRsub and Fsub elected to defer payment of the ACT to the distributions that DRsub made to USparent. DRsub paid $E and $F of ACT to the U.K. Inland Revenue with respect to the Date X and Date Y distributions, respectively. With regard to the ACT payments, DRsub elected to surrender the U.K. mainstream corporate tax offset to Fsub. Fsub used most of the surrendered ACT to offset its Year 1 U.K. mainstream corporate tax liability and carried forward the remainder.

With respect to the Date Y distribution and related payment of ACT, USparent received pursuant to Article 10(2)(a)(i) of the U.S.-U.K. Income Tax Treaty ("Treaty")[1] a provisional ACT refund from the U.K. Inland Revenue in the amount of one-half of the ACT paid, or $G, reduced by a 5% withholding tax on the sum of the distribution and ACT refund. However, with regard to the Date X distribution and related payment of ACT, the U.K. Inland Revenue has denied USparent's claim for an ACT refund.

Pursuant to Article 10(2)(a)(i) of the Treaty, the U.K. imposed a 5% withholding tax on the aggregate of the Date Y distribution from DRsub to USparent and ACT refund paid to USparent. The U.K. Inland Revenue has not imposed a withholding tax with respect to the Date X distribution, since under the Treaty the tax is withheld only from the ACT refund, which has not been paid.

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[1]Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, TIAS 9682, 1980-1 C.B. 394.

With respect to its consolidated return for Year 1, which included DRsub, USparent included in gross income as dividends $C of the Date X distribution and the entire amount of the Date Y distribution received by DRsub from Fsub. USparent eliminated from gross income the corresponding intercompany dividends that it received from DRsub. Treas. Reg. §1.1502-14(a)(1). For purposes of resolution of the issues presented here, it is assumed that only $C of the Date X distribution is treated for U.S. tax purposes as a dividend paid by Fsub to DRsub, and that the remainder of the Date X distribution, $B, is disregarded for U.S. tax purposes pursuant to the "circular cash flow doctrine." The entire Date X distribution from DRsub to USparent and the next-day recontribution is disregarded for the same reason.

Also for Year 1, USparent claimed foreign tax credits under section 901 of the Code for the unrefunded ACT paid by DRsub and withholding tax payments in the following amounts:

1. $E of ACT with respect to the Date X distribution,
2. $G of ACT with respect to the Date Y distribution, and
3. $H of withholding tax with respect to the Date Y distribution and ACT refund.

USparent did not characterize on its return the unrefunded ACT and withholding tax as taxes on FOGEI.

LAW AND ANALYSIS

1. Character of Dividends Received by DRsub from Fsub

Section 907(a) of the Code imposes an annual limit on the amount of foreign taxes paid on FOGEI that can be credited under section 901 against the U.S. tax liability of U.S. taxpayers. The limitation is a certain percentage of FOGEI. The percentage limitation for corporate taxpayers for Year 1 was the highest U.S. corporate tax rate for the year. Foreign taxes paid on FOGEI in excess of the section 907(a) limitation are not deductible as taxes or as royalties but may be carried back for two years or forward for five years subject to the section 907(a) limitation in the year to which the taxes are carried.

For Year 1, FOGEI is defined in section 907(c)(1) of the Code as:

> taxable income derived from sources without the United States and its possessions from-

(A) the extraction (by the taxpayer or any other person) of minerals from oil and gas wells, or

(B) the sale or exchange of assets used by the taxpayer in the trade or business described in subparagraph (A).[2]

In 1993 Congress revised section 907(c)(1) of the Code to provide that FOGEI "does not include any dividend or interest income which is passive income (as defined in section 904(d)(2)(A)."[3] That revision is effective for tax years beginning after December 31, 1992. However, FOGEI includes dividends received "from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902 *** to the extent such dividends *** are attributable to" FOGEI. Section 907(c)(3). Treas. Reg. §1.907(c)-2(d)(1)(i) employs a proportionality test to determine the amount of the dividend that is attributable to FOGEI.[4] The portion of the dividend that will be FOGEI under the regulatory test equals-

Amount of dividend x a/b

a = FOGEI accumulated profits in excess of FOGEI taxes paid or accrued, and
b = Total accumulated profits in excess of total foreign taxes paid or accrued.

Although under section 907(c)(3) of the Code dividends may be characterized as FOGEI, under section 907(c)(1) they will lose that characterization to the extent that the dividends are classified as passive income under section 904(d)(2)(A). Under section 904(d)(2)(A), passive income means income "of a kind which would be foreign personal holding company income (as defined in section 954(c))." Under section 954(c)(1)(A), foreign personal holding company income includes dividend income. However, passive income does not include any income that would fall within any of the other section 904(d) separate limitations, any export financing

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[2]FOGEI does not include income attributable to processing, transporting or distributing oil and gas or their primary products or to the disposition of assets used in such activities. Such income is foreign oil related income ("FORI"). Section 907(c)(2); Treas. Reg. §1.907(c)-1(c).

[3]Omnibus Budget Reconciliation Act of 1993, 107 Stat. 312, 504-505, P.L. 103-66, §13235(a)(1)(A).

[4]A similar rule for section 960 amounts was adopted in Treas. Reg. §1.907(c)-2 (d)(4). Both rules are similar to Treas. Reg. §1.901-3(b)(2)(i)(a), relating to dividends attributable to foreign mineral income, which is based on section 901 (e)(2)(A), a provision identical in all material respects to section 907(c)(3).

interest, or any high-taxed income. Section 904(d)(2)(A)(iii)(I), (II), and (III).[5] Dividends received from a controlled foreign corporation in which the taxpayer is a United States shareholder, such as the dividends received here by DRsub from Fsub, may be excluded from passive income under the "look-through rule" of section 904(d)(3)(D), which provides that dividends "shall be treated as income in a separate category in proportion to the ratio of (i) the portion of the earnings and profits attributable to income in such category, to (ii) the total amount of earnings and profits." *See* Treas. Reg. §1.904-5(c)(4).

Here, the look-through rules of sections 907(c)(3) and 904(d)(3)(D) of the Code operate to characterize most of the Date X dividend of $C and Date Y dividend of $D received by DRsub from Fsub as FOGEI, since most of Fsub's earnings and profits were FOGEI. DRsub met the required section 902 ownership requirement of section 907(c)(3). Under section 902, U.S. corporations owning at least 10% of the voting stock of a foreign corporation are deemed to have paid a share of the foreign income taxes paid by the foreign corporation in the year in which the corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder.

2. Character of ACT paid by DRsub on distributions to Usparent

Under the ACT prior to its repeal effective April 6, 1999[6], any corporation making a qualifying distribution was liable for payment of ACT on that distribution. If a lower-tier corporation, such as Fsub, paid ACT, the distribution was a franked distribution and could be distributed by an upper-tier corporation, such as DRsub, without incurring additional liability for ACT. Income and Corporate Taxes Act ("ICTA") 1988, §§238(1) and 241(1) and (3). However, related U.K. corporations could make a group election permitting the group to shift liability for ACT by making unfranked distributions within the group. ICTA 1988, §247. If the group election was made and the lower-tier corporation made an unfranked distribution to an upper-tier corporation, liability for ACT attached to the upper-tier corporation when it made a distribution to shareholders. ICTA 1988, §239. Here, DRsub and Fsub made the group election and, therefore, the Date X and Date Y distributions from Fsub to DRsub were unfranked distributions so that DRsub was liable for the ACT on its distributions to USparent.

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[5]In 1993, in connection with the revision made to the definition of FOGEI, Congress also deleted section 904(d)(2)(A)(iii)(IV), which provided that passive income for purposes of the separate passive income limitation of section 904(d) did not include FOGEI.

[6] Dates X and Y were prior to April 6, 1999.

The corporation paying the ACT could use it to offset its U.K. mainstream corporate tax liability. If the ACT paid exceeded current year U.K. mainstream corporate tax the excess could be carried back for 6 years or forward indefinitely to be used as an offset in those years. ICTA 1988, §239(3) and (4). Alternatively, the payor corporation could surrender the ACT to one or more of its 51% owned subsidiaries. ICTA 1988, §240. If the ACT was surrendered, the lower-tier subsidiary was treated as having paid the surrendered ACT and could use it to offset its liability for U.K. mainstream corporate tax. ICTA 1988, §240(2). The corporation surrendering the ACT was no longer treated as having paid the ACT. ICTA 1988, §240(7). Here DRsub surrendered to Fsub the ACT that it paid with regard to the Date X and Date Y distributions. Fsub used most of the surrendered ACT to offset its Year 1 U.K. mainstream corporate tax liability and carried forward the remainder.

U.K. resident individual shareholders were entitled to a “shareholder credit” against their individual taxes for a portion of the ACT paid on the distribution. The credit was refundable if it exceeded the shareholder’s tax liability. ICTA 1988, §231(1).

Under Article 10(2)(a)(i) of the Treaty, U.S. corporate shareholders, such as USparent, owning at least 10 percent of the stock of a resident U.K. corporation, such as DRsub, are entitled to a refundable tax credit, paid directly from the U.K. government, equal to one-half of the shareholder credit, or one-half of the ACT paid, with respect to dividends received from the U.K. subsidiary. The sum of the payment from the U.K. government and the dividend paid by the U.K. subsidiary is treated, under Article 10(2)(a)(iii), as a dividend for U.S. foreign tax credit purposes and is subject, under Article 10(2)(a)(i), to U.K. withholding of 5 percent. The 5% withheld is treated as a creditable income tax paid by the U.S. corporate shareholder. Article 23(1)(b).

Under Article 23(1)(c) of the Treaty, the amount of ACT paid by the distributing corporation and not refunded under Article 10(2)(a)(i) is treated as a creditable income tax of the distributing U.K. corporation. Article 23 provides that the allowable amount of the U.S. foreign tax credit for ACT shall be determined “[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)."

The Technical Explanation to the Treaty, Rev. Proc. 80-18, 1980-1 C.B. 623, and Rev. Proc. 90-61, 1990-2 C.B. 657, address timing issues that are not specifically addressed in the text of the Treaty. These authorities defer the portion of the allowable foreign tax credit attributable to ACT surrendered by a payor corporation to one or more of its 51% owned subsidiaries, such as the surrender of the ACT paid by DRsub to Fsub, until the credit would be available under section 902 or 960 in connection with a distribution or inclusion from the subsidiaries. The revenue procedures treat the unrefunded portion of the surrendered ACT as a tax paid by the subsidiary receiving the surrendered ACT and not by the corporation

surrendering the ACT. The refunded portion of the ACT is treated as refunded to and distributed by the U.K. corporation to the U.S. shareholder as a dividend.

The Court of Appeals for the Federal Circuit in *Xerox Corporation v. United States*, 41 F.3d 647 (Fed. Cir. 1994) *revg.* 14 Cl. Ct. 455 (1988), held that the surrender of the ACT had no effect on the timing of the foreign tax credit for the ACT since under Article 23(c)(1) of the Treaty the payor of the ACT is the corporation that pays the dividend and corresponding ACT, and not the subsidiary that received the benefit of the surrendered ACT. The U.S. Tax Court in its recent decision in *Compaq Computer v. Commissioner*, 113 T.C. 363 (1999), agreed with the Federal Circuit.

The facts here are not identical to those in either *Xerox* or *Compaq Computer* since DRsub, the corporation that paid the ACT, is a dual resident corporation. Nonetheless, under those opinions, since DRsub, a U.S. corporation, is considered to have paid the ACT, the credit for the unrefunded portion of the ACT would be allowed to the USparent group under section 901. Under the Technical Explanation and the revenue procedures, credit for the unrefunded portion of the ACT paid by DRsub and surrendered to Fsub would be allowed to the USparent group only under section 902 in connection with a distribution from Fsub. Under either analysis, however, a ratable portion of the creditable ACT would be taxes on FOGEI.

Section 907(c)(5) of the Code defines taxes on FOGEI as creditable income taxes that are paid or accrued or deemed paid under section 902 or 960 with respect to FOGEI. Treas. Reg. §1.907(c)-3(a) "provides rules for the characterization *** of the income taxes *** paid or accrued to a foreign country among FOGEI, FORI, and other income relevant for purposes of sections 907 and 904." The regulations refer to FOGEI, FORI and other income as "classes of income." Treas. Reg. §1.907(c)-3(a)(2). These regulatory rules are relevant here irrespective of whether the ACT is considered to have been paid by DRsub under *Xerox* and *Compaq Computer* or paid by Fsub under the Technical Explanation and revenue procedures, since both DRsub and Fsub have more than one such class of income composed in part of FOGEI and since the ACT is considered a corporate-level income tax under Article 23(1)(c) of the Treaty. As stated above in the facts and in Issue 1, most of Fsub's earnings and profits were FOGEI. Therefore, the major part of the distributions received by DRsub from Fsub was also FOGEI.

Treas. Reg. §1.907(c)-3(a)(4) requires that "the pre-credit foreign tax for the base [be] apportioned to each class of income in proportion to the income of each class. Tax credits are then allocated *** to the apportioned pre-credit tax." Under the analysis set forth in the Technical Explanation and revenue procedures, the regulation will operate to characterize, in the proportion that FOGEI is to all of the earnings and profits of Fsub, the creditable ACT treated as paid by Fsub as FOGEI taxes. That characterization as FOGEI taxes of Fsub's taxes that are deemed paid

by DRsub under section 902 in connection with taxable dividends paid from Fsub to DRsub will flow through to the USparent group by operation of section 907(c)(3).

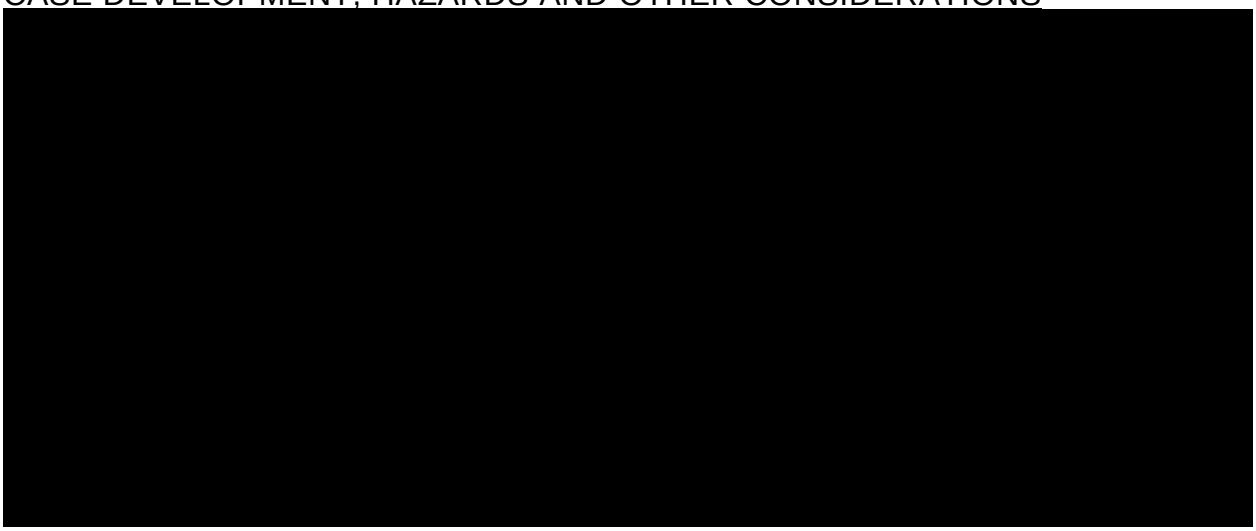
Likewise, under the analysis set forth in *Xerox* and *Compaq Computer*, the regulation will apply directly to characterize, in the proportion that FOGEI is to all of the earnings and profits of DRsub, the creditable ACT paid by DRsub as FOGEI taxes. ACT treated under the court cases as paid by DRsub with respect to both the Date X and Date Y distributions are taxes imposed in large part on FOGEI earnings even though, as stated above in the facts, both distributions from DRsub to USparent are eliminated from income for U.S. tax purposes pursuant to the "circular cash flow doctrine" or under the consolidated return regulations. *See* Treas. Reg. §1.904-6(a)(1)(iv) (providing rules for the allocation and apportionment of foreign taxes to separate limitation categories in situations involving timing differences).

3. Character of 5% Withholding Tax

Pursuant to Article 10(2)(a)(i) of the Treaty, the U.K. imposed a 5% withholding tax on the aggregate of the Date Y distribution from DRsub to USparent and the ACT refund received by USparent with regard to that distribution. The U.K. Inland Revenue has not imposed a withholding tax with respect to the Date X distribution.

As stated above in Issue 1, most of the Date X and Date Y distributions received by DRsub from Fsub was FOGEI since most of Fsub's earnings and profits were FOGEI. Treas. Reg. §1.907(c)-3(a)(7) provides that "[t]he portion of the total withholding taxes on a distribution that constitutes FOGEI taxes is determined by the portion of the distribution that is FOGEI." Accordingly, the portion of the 5% withholding taxes paid to the U.K. Inland Revenue that is FOGEI taxes will equal the portion of DRsub's total accumulated earnings and profits that is FOGEI.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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

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