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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR Industry Director
Heavy Manufacturing and Transportation
LM:HMT

FROM: Chief, CC:INTL:Br3

SUBJECT:

On October 10, 2001, Taxpayer's authorized representative withdrew a private letter ruling request after being advised that this office would issue an adverse ruling, in part, in response to that request. Pursuant to Section 8.07(2)(b) of Rev. Proc. 2001-1, 2001-1 I.R.B.1, 32, we hereby notify you of that fact and set forth below our views on the issues presented in that request. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

USsub =
Fsub =
Country A =
Treaty =

$B =
$C =
D% =
Article E =
Article F =

ISSUES

1. Whether Taxpayer will be deemed under sections 960(a)(3) and 902 of the Internal Revenue Code to have paid foreign income taxes in the amount of $C paid by Fsub with respect to $B when distributed.

2. Whether Country A taxes that will be withheld on the anticipated distribution of $B will be creditable under section 901 of the Code.

CONCLUSIONS

1. Taxpayer will not be deemed under sections 960(a)(3) and 902(a) of the Code to have paid foreign income taxes paid by Fsub with respect to $B.

2. Country A taxes that will be withheld on the anticipated distribution will be creditable under section 901 of the Code.

FACTS

Fsub is a Country A corporation and is wholly owned by USsub. USsub is wholly owned by Taxpayer. Both Taxpayer and USsub are U.S. corporations and file a consolidated income tax return.

Fsub plans to make a distribution to USsub[1] in an amount equal to its current earnings and profits and amount $B. If made, the distribution will be subject to a Country A withholding tax of D% pursuant to the income tax treaty between the U.S. and Country A ("Treaty").

LAW AND ANALYSIS

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[1]In light of the fact that Taxpayer withdrew its ruling request after being advised that it would not receive the desired favorable tax consequences on the distribution, it is unclear whether Fsub will in fact make the distribution.

Section 901 of the Code allows U.S. taxpayers a credit, subject to the limitations of section 904(a) and (d), for foreign income taxes paid or accrued. In addition, section 903 provides that “a tax paid in lieu of a tax on income ... otherwise generally imposed by any foreign country” will be creditable. Provided certain ownership requirements are met, section 901 also allows a domestic corporation to claim a credit for foreign income taxes paid by its foreign subsidiary and deemed paid by the domestic corporation under section 902 or 960.

1. <u>Deemed paid credit with respect to the distribution of $B</u>

Section 902(a) of the Code provides that a domestic corporate shareholder owning 10 percent or more of the voting stock of a foreign corporation shall be deemed to have paid a ratable portion of the foreign corporation's taxes when the foreign corporation distributes a dividend. The domestic corporation must own the requisite voting stock at the time it receives a dividend. Section 960 provides rules similar to those of section 902, allowing a U.S. shareholder of a controlled foreign corporation to claim a credit for foreign taxes paid by the controlled foreign corporation and deemed paid by the U.S. shareholder with respect to amounts included in gross income under section 951(a).

For pre-1987 taxable years, deemed-paid taxes were determined based on annual accounts of earnings and taxes from which dividend distributions were sourced on a last-in, first-out basis. Congress in 1986 revised section 902 of the Code to provide that the U.S. shareholder of a foreign corporation determines the amount of foreign taxes deemed paid by it on the basis of multi-year pools of undistributed earnings and foreign income taxes. Revised section 902 generally applies to earnings and profits accumulated in years beginning after December 31, 1986, and foreign income taxes attributable to those earnings.

Section 78 of the Code requires a domestic corporation that computes an amount of deemed paid taxes under section 902(a) or section 960 to include the amount of taxes deemed paid in gross income as a dividend in the year the foreign taxes are deemed paid. The domestic corporation's income is thus the sum of the dividend or section 951(a) inclusion and the foreign taxes deemed paid.

Section 959 of the Code addresses the tax treatment of distributions out of earnings previously included in the gross income of a U.S. shareholder under section 951(a) (“PTI distributions”). Section 959(a) provides, in relevant part, that earnings and profits for a taxable year of a foreign corporation attributable to amounts that are or have been included in the gross income of a U.S. shareholder under section 951(a) shall not, when such amounts are distributed to that shareholder directly or indirectly, be included in gross income again. However, a PTI distribution may result in the recognition of exchange gain or loss under section 986(c).

Except as provided in section 960(a)(3) of the Code, any distribution excluded from gross income under section 959(a) is treated as a distribution which is not a dividend, except that the distribution immediately reduces the CFC's earnings and profits. Section 959(d).

If additional taxes are imposed on a distribution of PTI, a U.S. shareholder may be entitled to additional foreign tax credits under section 960(a)(3) of the Code. Section 960(a)(3) provides that:

> [a]ny portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 959(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such distribution is made, which were not deemed paid by the domestic corporation under [section 960(a)](1) for any prior taxable year.

[2]

[2]

Even though the amount of $B will, we assume, be treated as PTI when distributed, section 960(a)(3) of the Code does not operate to allow USsub to claim a deemed paid credit for any portion of the $C in Country A income taxes paid by Fsub with respect to that amount. The sole example in the Committee Reports that accompanied the enactment of section 960(a)(3) of when it would apply is "[w]here the foreign country imposes a tax directly on dividend distributions, such a tax would not ... initially be taken into account when the shareholder at an earlier date was taxed on undistributed earnings of a controlled foreign corporation." H.R. Rep. No. 1447, 87th Cong. 2nd Sess. 66 (1962) and S. Rep. No. 1881, 87th Cong. 2nd Sess. 94 (1962). Section 960(a)(3) is designed to apply only if a lower-tier subsidiary distributes PTI to a upper -tier subsidiary, and the upper-tier subsidiary pays a withholding tax or other income tax with respect to the PTI that is taxed as a dividend by the foreign country. When the upper-tier subsidiary distributes the PTI to its domestic parent corporation, the parent will compute an amount of deemed paid taxes under sections 960(a)(3) and 902 with respect to the PTI distribution and the additional taxes imposed on the PTI. Because the PTI on which the additional taxes are imposed and out of which they are paid was previously included in the U.S. shareholder's income under section 951, the additional taxes will not be included in gross income as an additional dividend under section 78. Treas. Reg. §1.960-3(b). The example in the Committee Report does not apply to the anticipated distribution from Fsub, a first-tier subsidiary.

Treas. Reg. §1.960-2(g)(1)(iii)(A) sets forth a formula to cover distributions by a first-tier corporation, such as Fsub, out of its earnings and profits for tax years beginning before January 1, 1987.

Under that formula, the taxes paid by the first-tier corporation which are deemed paid by a domestic corporation, such as Taxpayer, under sections 960(a)(3) and 902(a) on that distribution will not include taxes attributable in whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the first-tier corporation.

See also Treas. Reg. §1.902-1(a)(10)(iii), providing that pre-1987 foreign income taxes available for credit are reduced by taxes paid by the foreign corporation on or with respect to amounts that are included in income from pre-1987 accumulated profits of that year.

2. <u>Direct credit with respect to withholding tax that will be payable on distribution</u>

Under Article E of the Treaty, the contemplated distribution will be subject to a withholding tax of D%. Article F of the Treaty also provides that the withholding tax that would be paid to Country A is considered an income tax for purposes of the foreign tax credit in the United States.

The purpose of the foreign tax credit is to relieve double taxation of foreign source income. See *American Chicle v. United States*, 316 U.S. 450 (1942) and Article F of the Treaty. However, no provision in section 901 or the regulations thereunder or the Treaty disallows credit for a foreign tax that, as a whole, meets the section 901 or Treaty creditability requirements, whichever is applicable, on the grounds that the foreign tax base includes items of income that constitute U.S. source income, or items that are not taxable, under the Internal Revenue Code. The Code does not restrict the allowable credit to foreign tax that is associated with specific items of foreign source income that are recognized both for U.S. and foreign purposes.

Thus, the law does not require a taxpayer to link the foreign tax to items of foreign source taxable income as computed under U.S. tax rules in order to claim credit for the tax. Rather, the foreign tax credit limitation under section 904 provides the mechanism to limit the allowable foreign tax credit to the U.S. tax on the taxpayer's foreign source income. *See Schering Corp. v. Commissioner*, 69 T.C. 579 (1978), *acq. in result*, AOD 1981-31 (credit allowed for Swiss withholding tax on payment treated as a dividend under Swiss law and as a nontaxable repayment of a receivable for U.S. purposes), and *Helvering v. Campbell & Helvering v. Nell*, 139

F.2d 865 (4th Cir. 1944), *I.B. Dexter v. Commissioner*, 47 B.T.A. 285 (1942), *acq*. 1948-2 C.B. 1, and *Brace v. Commissioner*, 11 T.C.M. 906 (1952)(all holding that the amount of foreign tax eligible for credit is not limited to the portion of the foreign tax paid that was allocable to amounts that were also included in income under U.S. tax law); *see also* Rev. Rul. 54-15, 1954-1 C.B. 129 (formally abandoning the position that the credit was so limited).

Accordingly, although the anticipated distribution in the amount of $B will not result in taxable income to USsub, Country A taxes withheld on the anticipated distribution will nonetheless be creditable under section 901 of the Code.

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

BARBARA A. FELKER
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