Office of Chief Counsel
Internal Revenue Service

Memorandum

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subject: Disallowance of Foreign Tax Credits Attributable to "Voucher Trade" Transactions

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Subsidiary =

ISSUES

1. Whether Subsidiary's choice as provided under United Kingdom (U.K.) law to use foreign dividend withholding taxes as a credit against its obligation to pay a non-creditable tax resulted in non-compulsory payments of its U.K. net income tax liability?

2. Whether the entire amount of foreign dividend withholding taxes paid by Subsidiary qualify for the "qualified tax" exception provided in section 901(k)(4) of the Internal Revenue Code.

CONCLUSIONS

1. Yes. Taxpayer failed to substantiate that Subsidiary's election under U.K. law to use foreign dividend withholding taxes as a credit against its liability for a non-creditable tax rather than its liability for the U.K. net income tax did not result in an increase, over time, of its liability for the U.K. net income tax. Subsidiary's payment of U.K. net income tax was noncompulsory to the extent that its liability for income tax could have been reduced by the foreign dividend withholding taxes that it used to reduce the non-creditable tax. Under Treas. Reg. §1.901-2, Taxpayer is not entitled to claim foreign tax credits with respect to the noncompulsory payment.

2. No. Under section 901(k)(4), a foreign dividend withholding tax is a "qualified tax" only to the extent that the payor is allowed to credit that foreign dividend withholding tax against its net income tax liability in the foreign country in which it is engaged in an active securities business. Because Subsidiary chose to credit the foreign dividend withholding taxes against its liability for a non-creditable tax, it was not allowed to credit such taxes against its net basis tax in the U.K. and, to that extent, the foreign withholding taxes were not a qualified tax within the meaning of section 901(k)(4).

FACTS

Throughout the years at issue, Taxpayer, a U.S. corporation, was engaged in the financial services business. Subsidiary, a wholly-owned U.K. subsidiary of Taxpayer, was also engaged in that business. Subsidiary both acquired and borrowed shares of companies resident in various foreign countries other than the U.K. Although Subsidiary did not generally maintain its interests in those shares for substantial periods, it often was the legal owner of the shares on the dividend payment date. As the legal owner it received dividends on those shares and paid the relevant foreign dividend withholding taxes. Subsidiary was subject to the U.K. net income tax with respect to its business activities.

In addition to the net income tax, during the years at issue, the United Kingdom imposed a separate levy on certain financial intermediaries that made payments in lieu of dividends with respect to shares of non-U.K. companies (manufactured overseas dividends or MODs) that they borrowed as part of their financial services businesses. Under that levy, the payor of MODs was required to pay a tax equal to the foreign withholding tax that would have been imposed had a dividend been paid directly from the non-U.K. company to the recipient of the substitute payment. Regulation 3, Income Tax (Manufactured Overseas Dividends) Regulations 1993 (U.K. Regulations). The U.K. Regulations referred to the levy on MODs as the relevant withholding tax (RWT). In addition, the payor of MODS was required to issue to the recipient a voucher that documented the amount of RWT that it paid. The recipient could then claim a credit against its U.K. net income tax for the tax reflected on the voucher. Under Regulation 9(1) of the U.K. Regulations, the payor of MODs was "entitled to set off" the foreign dividend withholding taxes against either the RWT imposed on the MODs or its net income tax liability. Accordingly, any foreign dividend withholding taxes that the payor of the MODs used as a credit against its RWT were ineligible to be used as a credit against its net income tax liability.[1]

During the years at issue, Subsidiary paid MODs that were subject to RWT and used a substantial portion of the foreign dividend withholding taxes that it paid as a credit against its RWT liability and not against its U.K. net income tax liability. Taxpayer claimed on its federal income tax returns for the years at issue foreign tax credits under section 902 or 960 for the foreign dividend withholding taxes imposed on dividends paid to Subsidiary by companies resident in foreign countries other than the U.K. In addition, Taxpayer has asserted in audit that it underreported in the years at issue foreign tax credits for those withholding taxes. Taxpayer also claimed on its federal income tax returns for the years at issue foreign tax credits under section 902 or 960 for Subsidiary's U.K. net income tax liability in each year, reduced by only the amount of foreign dividend withholding taxes that exceeded the RWT owed in that year.

LAW AND ANALYSIS

A. <u>Noncompulsory Payment</u>

Section 901 permits a taxpayer to claim a credit for income, war profits and excess profits taxes ("income taxes") paid or accrued (or deemed paid) to a foreign country. The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign source income. *See American Chicle Co. v. United States*, 316 U.S. 450, 451 (1942).

Treas. Reg. §1.901-2 provides detailed guidance on the criteria used to determine whether a foreign levy is an income tax for purposes of section 901. In general, the levy must be a tax and its predominant character must be that of an income tax in the U.S. sense. Treas. Reg. §1.901-2(a)(1). A tax imposed in lieu of an income tax otherwise generally imposed by a foreign country is treated as an income tax for section 901 purposes. Section 903. To qualify as a tax "in lieu of" an income tax, the foreign levy must be a tax and must be "imposed in substitution for, and not in addition to, an income tax or series of income taxes otherwise generally imposed." Treas. Reg. §1.903-1(a) and (b).

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[1] For example, assume a taxpayer had borrowed a share of French Stock 1 from Lender in connection with a short sale and simultaneously held a share of German Stock 1. Also assume that French Stock 1 and German Stock 1 both paid dividends of 100 with respect to one of their shares and that France and Germany both withheld 10 from such payments, resulting in net dividend payments of 90. When the taxpayer made a MOD payment to Lender of 90 with respect to the share of French Stock 1 it borrowed, the taxpayer was obligated to pay the U.K. an RWT equal to 10, i.e., the amount that France would have withheld had the dividend been paid directly to Lender. The taxpayer also had dividend income of 100 from German Stock 1 and was eligible to claim a tax credit of 10 with respect to the German withholding tax. If, however, the taxpayer used the credit of 10 to offset its RWT obligation, that credit was not available to offset the taxpayer's obligation for U.K. net income taxes.

Whether a foreign levy qualifies as an income tax or tax in lieu of an income tax is determined independently for each separate levy imposed by a foreign country. Treas. Reg. §1.901-2(a)(1) and (d). A foreign taxing authority is viewed as imposing separate levies "where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy." Treas. Reg. §1.901-2(d).

Once the creditability of a foreign tax is established, a taxpayer must establish the amount of tax that was both owed and actually paid. Treas. Reg. §1.901-2(e)(1). A person cannot claim a credit with respect to amounts paid that are not owed under foreign law. Treas. Reg. §1.901-2(e)(5). Under that regulation, "[a]n amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax." That regulation provides further that a taxpayer cannot claim a credit for an amount paid if it fails "to reduce, over time, [its] reasonably expected liability under foreign law for tax."

The courts have long recognized that taxpayers must prove entitlement to the foreign tax credits they claim. For example, the 10th Circuit Court of Appeals stated that "[t]he general rule in tax law is that tax credits are a matter of legislative grace, and taxpayers bear the burden of clearly showing that they are entitled to them." *Schumacher v. United States*, 931 F.2d 650, 652 (10th Cir. 1991) (citations omitted).

As stated above, under Regulation 9(1) of the U.K. Regulation, a taxpayer "shall be entitled to set off" its foreign withholding taxes against the RWT imposed on substitute payments. Apparently relying on this regulation, Subsidiary elected to use the foreign dividend withholding taxes that it paid on the dividends it received while it was the legal owner of the foreign company stock as a credit against its liability for the RWT rather than as a credit against its U.K. net income tax liability. Because of the use of the words "entitled to", the regulation appears to be elective. Taxpayer has not provided any evidence that Subsidiary could not have chosen to use the foreign withholding taxes that it paid on the dividends it received as a credit against its U.K. net income tax liability rather than against its RWT liability.

By electing to use the foreign dividend withholding taxes as a credit against its liability for the RWT rather than as a credit against its U.K. net income tax liability, Subsidiary reduced or eliminated its RWT liability. However, at the same time, it reduced the credits available to offset its U.K. net income tax liability. Taxpayer did not offer any evidence that Subsidiary's liability for the U.K. net income tax would not have been "reduced . . . over time" had it instead applied the credits against that liability. Under these circumstances, Taxpayer has not met its burden of establishing that a portion of Subsidiary's U.K. net income tax liability for which it claimed foreign tax credits in the U.S. during the years at issue was a compulsory payment under Treas. Reg. §1.901-2(e)(5). Accordingly, it is appropriate to disallow any foreign tax credits attributable to an amount of Subsidiary's U.K. net income tax liability equal to the amount of the foreign dividend withholding taxes that were used as a credit against Subsidiary's liability for the RWT. That is the maximum amount by which the U.K. net income tax might have been reduced by the U.K. credits.

We point out that had the RWT liability been a creditable tax under either section 901 or 903, none of Subsidiary's U.K. net income tax liability would have been a noncompulsory payment due to the fact that the foreign dividend withholding taxes were used as a credit against the RWT. In that event, Subsidiary's choice to apply the foreign dividend withholding taxes as a credit against either of the creditable taxes would be expected, under Treas. Reg. §1.901-2(e)(5), to "reduce, over time, [its] reasonably expected liability under foreign law for tax." In this case, however, the RWT is not a creditable tax imposed on Subsidiary. The predominant character of the levy is not that of an income tax because it is imposed with respect to substitute payments made by Subsidiary, which are an expense rather than an income item of Subsidiary. Similarly, the RWT does not qualify as a tax "in lieu of" an income tax because it is not imposed in substitution for any part of the net income tax imposed on Subsidiary, the payor of the MODs. Therefore, the use of the foreign dividend withholding taxes as a credit to offset the RWT reduces or eliminates a levy that would not be creditable for U.S. tax purposes by increasing Subsidiary's liability for the otherwise creditable U.K. net income tax imposed on Subsidiary's net income.

B. <u>Section 901(k)</u>

Under section 901(k)(1), foreign tax credits attributable to withholding taxes imposed on dividends are disallowed either if the recipient of the dividend does not meet certain holding period requirements or if the recipient of the dividend is under an obligation to make related payments with respect to substantially similar or related property. Congress added this disallowance provision to the Code in order to preclude a taxpayer from claiming foreign tax credits where the taxpayer generally would not recognize net income and, therefore, would not be subject to double taxation. *See* General Explanation of Tax Legislation Enacted in 1997, JCS-23-97, at 246 (noting that objectionable transactions "allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits" and comparing holding period requirement for foreign tax credits to similar restrictions under section 246(c)); *cf.* Technical Amendments Act of 1957, H. Rep. No. 775 (holding period requirements adopted in section 246(c) because taxpayers had claimed deductions with respect to dividends paid on shares without recognizing net income).

Section 901(k)(4) provides an exception to the disallowance provision of section 901(k)(1) described above. Under the exception, otherwise creditable foreign dividend withholding taxes are not disallowed if they are imposed with respect to "any security held in the active conduct in a foreign country of a business as a security dealer" but only if the foreign dividend withholding tax is a "qualified tax" as defined in section 901(k)(4)(B). A withholding tax is a "qualified tax" only if (1) it is imposed by a foreign country other than the foreign country in which the dealer is actively engaged in business, (2) the dividend is subject to tax on a net basis in the foreign country in which the dealer is actively engaged in business, and (3) the foreign country in which the dealer is actively engaged in business "allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country." *Id*.

The effect of the "qualified tax" exception is to permit foreign tax credits for foreign dividend withholding taxes in the limited circumstance in which the dividend income arises in the active conduct of a securities business in a foreign jurisdiction and such dividends would have been subject to net basis tax in that jurisdiction if the withholding tax had not been imposed. In those cases, in which the withholding tax effectively substitutes for a creditable net basis tax, Congress determined that it was inappropriate to apply the disallowance provision.

Taxpayer's position is that the foreign dividend withholding taxes[2] at issue are "qualified taxes" under section 901(k)(4)(B). As support for its position, Taxpayer asserts that (1) Subsidiary was actively engaged in business in the U.K. as a securities dealer, (2) the dividends at issue were subject to U.K. net basis tax, and (3) the withholding taxes were fully credited against either the U.K. net basis tax or the RWT. With respect to the third requirement, Taxpayer contends that the RWT "is a U.K. Income Tax Liability . . . . The foreign tax withheld from its non-U.K. dividends are thus fully creditable against its U.K. income tax liability." [3]

In our opinion, not all of the foreign dividend withholding taxes at issue are qualified taxes. We agree that Taxpayer has met the first two requirements, as set forth above. However, Taxpayer has not satisfied the third requirement. Taxpayer concedes that under U.K. law, Subsidiary could not use as a credit against its U.K. net basis tax liability any foreign dividend withholding taxes that it chose to use as a credit to offset its RWT liability. In our opinion, Subsidiary's use of the foreign dividend withholding taxes as a credit against its RWT liability falls outside the plain meaning of section 901(k)(4) because, as described above, the RWT is not a "net basis" tax. RWT is imposed on an expense, rather than income, of Subsidiary. Accordingly, because Subsidiary chose, as it was entitled to under Regulation 9(1) of the U.K. Regulation, to credit a substantial proportion of the foreign dividend withholding taxes against its RWT liability rather than against its U.K. net basis tax, the U.K. did not "allow a credit against its net basis tax for the <u>full amount</u> of the tax paid to such other jurisdiction." *Id* (emphasis added). In light of the emphasized language, an argument could be made that none of the foreign dividend withholding taxes paid by Subsidiary are qualified taxes, since the "full amount" of such taxes were not allowed as a credit against its U.K. net basis tax. However, it is

[2] Our analysis of whether the foreign dividend withholding taxes paid by Subsidiary are "qualified taxes" will be made on a combined basis because the large number of such taxes paid makes it impractical to analyze each such tax individually.

[3] Taxpayer did not argue that Subsidiary's interests in the shares with respect to which the foreign withholding taxes were imposed are not described in section 901(k)(1)(A)(i). However, the proposed disallowance would not apply to the extent that Taxpayer proved that Subsidiary's interests did not fail the holding period or related payment requirements of section 901(k).

our opinion that the foreign dividend withholding taxes are qualified taxes to the extent that Subsidiary used those taxes as a credit against its U.K. net basis tax liability. It is to that extent that the foreign dividend withholding taxes in fact substituted for the otherwise creditable net basis tax imposed by the U.K.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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

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