

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference: No Conference Held

LEGEND:

Taxpayer	=
Business A	=
French CFCs	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
K	=
L	=
M	=
N	=
O	=

ISSUE: Whether the French research tax credit is a "credit" within the meaning of Treas. Reg. §1.901-2(e)(2)(i) and, therefore, reduces the amount of foreign income

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taxes paid by the French CFCs for foreign tax credit purposes.

CONCLUSION:

Because more than a de minimis amount of the French research credit is refundable to taxpayers within a reasonable period of time, the French research credit is not a credit within the meaning of Treas. Reg. §1.901-2(e)(2)(i). Accordingly, no reduction in foreign taxes paid by the French CFCs is required.

FACTS:

Taxpayer is a domestic corporation that operates Business A in France through several controlled foreign corporations as defined in section 957 of the Internal Revenue Code (French CFCs). The French CFCs are subject to the generally imposed French corporate income tax. Taxpayer claimed deemed paid foreign tax credits on its United States consolidated income tax return for Years 1 through 4 under sections 902 and 960 for corporate income taxes paid to France by its French CFCs.

For Years 1 through 4, the French CFCs on their French integrated (*i.e.*, consolidated) corporate income tax return claimed French research and development tax credits, as described below, in the following amounts:

<u>Tax Year</u>	<u>French Francs</u>	<u>Average Exchange Rate</u>	<u>US \$</u>
Year 1	B	G	K
Year 2	C	H	L
Year 3	D	I	M
Year 4	E	J	N
Totals	F		O

The French research credits claimed in each year reduced the current corporate income taxes owed by the French CFCs in each respective year. In those years, none of the credits were refunded to the French CFCs.

For Years 1, 2, and 3, Taxpayer treated the French research credits as reductions of foreign tax paid for purposes of the amount of income taxes deemed paid under sections 902 and 960 of the Code. On its Year 4 Form 1118, Taxpayer took the position that the French research credits should not be treated as reducing creditable foreign taxes but rather should be treated as increasing income for purposes of the French CFCs' earnings and profits. Taxpayer has submitted informal claims to change its treatment of the French research credits for Years 1, 2, and 3 to conform to Taxpayer's treatment of those credits in Year 4.

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French research credit

In 1983 the French Parliament enacted a provision granting a tax credit for research expenditures. Specifically, the French tax code was amended to provide that an industrial or commercial firm subject to the French corporate income tax that increased its qualifying research and development expenditures in any year as compared with the previous year (subject to adjustment based on the increase in the consumer price index) was eligible to elect a credit against its corporate income tax liability (the "French research credit"). At the time of its enactment, the credit was equal to 25% of the increase in qualifying expenses, subject to an annual credit limitation of 3 million French francs. The parent corporation of a consolidated group reduced its corporate income tax by the total research credits earned by members of the group. If the credit exceeded the tax due, the excess was immediately refundable to the taxpayer.¹ The credit was not considered taxable income to the recipient.² A negative adjustment to the French research credit in the succeeding year was required if there was a decrease in research expenditures in the current year. In addition, for purposes of determining taxable income, taxpayers could also either claim a current deduction for the research expenditures or include those expenditures as part of inventory costs.³

The legislative history of the act establishing the French research credit indicates that the credit was instituted to increase the competitiveness of the French production system through the development of scientific and technical research. That history indicates also that a tax incentive (*i.e.*, the French tax credit) was preferred to direct public research subsidies because of a desire to eliminate bureaucracy which made applying for direct subsidies cumbersome. The legislative history also indicates a belief that the French research credit program would be easier and less expensive to administer than a direct subsidy.⁴ Direct subsidies are subject to stringent pre-conditions to their use. In contrast, the French research credit does not involve interference with the business's determination of the nature and usage of the research to be conducted. Nonetheless, government agencies at all levels (state, regions, and cities) as well as public institutions continue to provide substantial direct subsidies for research. These direct subsidies are deducted from the calculation base of the French

¹ Article 223, quater O 1-b and Article 244, quater B-I, ¶3, French Tax Code.

² Section 67 of the Finance Act 1983 (Act No. 82-1126).

³ Taxpayers were not allowed to reduce an estimated tax payment by any portion of a research subsidy received or to be received.

⁴ (Official Journal of Parliamentary Proceedings or Documents from the Assemblée Nationale ("JO AN"), session of November 8, 1982, p. 6917).

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research credit.⁵

The French research credit was extended and modified numerous times between 1983 and 1993, with the general intention of widening the scope of the credit to make it available to more businesses, while at the same time limiting the potential for tax avoidance. Some of the most significant changes included expansion of the definition of qualifying expenditures, expansion of the program to include agricultural businesses, use of the average of the preceding two years', rather than one year's, research expenditures as the base, doubling of the credit rate from 25% to 50%, and gradual increase of the annual credit limitation to 40 million French francs.⁶ All of these changes were effective for Years 1 through 4.

Beginning in 1992, only newly created corporations could obtain an immediate refund if the French research credit exceeded current year corporate income tax liability. With regard to all other corporations, including the French CFCs, any credit which was not immediately used to offset current income taxes could be carried forward and applied for up to three years against future income tax liability. Any unused credits remaining after the carryforward period were fully refundable, without interest. Years 1 through 4 are years after 1992.

The deferred refund scheme was enacted for two reasons: to combat tax avoidance and fraud, and to help balance the national budget by reducing the outflow of funds from the Treasury.⁷ The establishment of the three-year deferral on refunds led to an immediate reduction in the overall cost of the research credit to the French treasury; the Assemblée Nationale Finance Committee estimated that the credit deferral regime would result in a savings of 2.5 billion French francs in 1993, or 39% of what the research credit would have cost had the modification not been made.⁸

For Years 1 through 4, in order to claim the credit, the French CFCs filed Form 2069A along with their integrated income tax return with the French tax authority. The tax authority had sole jurisdiction over determining the allowability of the claimed research credit. However, the tax authority could, in complex situations, request the assistance of the Ministry for Research. One copy of Form 2069A was sent to the Ministry of Research in order to facilitate the requested assistance. The Treasury service (which like the tax authority is under the jurisdiction of the Minister of Finance) also played a

⁵ Article 244, quater B-III, ¶1, French Tax Code

⁶ Article 244, quater B, French Tax Code.

⁷ JO AN, session of October 23, 1992, p. 4210.

⁸ JO AN, session of October 23, 1992, p. 4210.

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function in the processing of the 2069A research credit form. The Treasury collector's duties included collecting taxes that are due and disbursing state expenses, including the refund of excess research credits. The Treasury collector received copies of Form 2069A and Form 2069 bis which must be filed to obtain a refund. The Treasury collector was responsible for monitoring the amounts of credit to be offset against current income taxes, credit carryforwards, and disbursing refunds of unutilized credits.

Although administered through the tax system, no funds within the Ministry of Finance's budget were earmarked for administration of the credit. In addition, refunds of the French research credit were not paid out of the budget for that ministry. There was no fund within the governmental budget specifically reserved for refunds of the French research credit.

The following table sets forth the percentages of the French research credit (i) used to reduce corporate tax liability, and (ii) paid as cash refunds for Years 1 through 4:

Tax Year	Usage of French Research Credit (%)				
	Tax Reduction:		Cash Refunds:		
	Current Year	Carry-forward	Start-up Businesses	Other Businesses	Total Cash Refunds
Year 1	38.0%	37.2%	3.0%	21.8%	24.8%
Year 2	45.1%	29.0%	2.6%	23.4%	26.0%
Year 3	42.6%	31.4%	1.9%	24.1%	26.0%
Year 4	42.1%	39.3%	1.4%	17.1%	18.5%

LAW AND ANALYSIS:

Section 901 of the Internal Revenue Code allows a credit against US income tax liability for the amount of certain income taxes paid to a foreign country or possession of the United States. 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 foreign income 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 income 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).

Under Section 901 of the Code, a foreign levy is a creditable income tax only if it is a tax and its predominant character is that of an income tax in the U.S. sense. Treas. Reg. §1.901-2(a)(1). Under Treas. Reg. §1.901-2(a)(2), a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy

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taxes. To be creditable the tax must be paid. Treas. Reg. §1.901-2(e)(1).⁹ Under Treas. Reg. §1.901-2(e)(2)(i), a foreign levy

is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

This rule is illustrated by Example (2) of Treas. Reg. §1.901-2(e)(2)(ii), in which an initial foreign income tax liability of 100u is reduced by an investment credit of 15u and a charitable contributions credit of 5u. Example (2) states that the amount of foreign income tax paid is 80u.

Treas. Reg. §1.901-2(e)(2) and Example (2), however, do not address a situation in which the amount of a credit is offset against the tax liability but would also be paid in cash to the taxpayer to the extent the taxpayer's income tax liability were less than the amount of the allowable credit. Under the French system, the research credit is paid to corporate taxpayers that make qualifying research expenditures without regard to the taxpayers' French corporate income tax liability; although the credit first is used to reduce the current year's French income tax liability, any excess allowable credit is either paid to the taxpayer (in the case of newly created corporations), or carried forward to offset the three subsequent years' tax liabilities and then paid to the taxpayer (in the case of all other corporations). Because taxpayers receive the full amount of the French research credit, either in cash or as an offset against their income tax liability, the crediting of the research credit against tax liability is appropriately viewed as the means of payment of the research credit, and not as a refund, credit, abatement, or forgiveness of French income tax liability within the meaning of Treas. Reg. §1.901-2

⁹ Article 24, paragraph 1(a)(i) of the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, that entered into force on December 30, 1995, (TIAS _____) (1995 Treaty) and Article 23, paragraph 1(a) of the Convention Between the United States of America and the French Republic with Respect to Taxes on Income and Property, that was brought into force August 11, 1968, (1968 Treaty) provide that the French corporate income tax to which the French CFCs were subject is a creditable tax. However, both conventions provide that the tax is creditable only if paid. Since neither convention defines the term "paid," the definition under U.S. law (*i.e.*, of Treas. Reg. §1.901-2(e)(2)(i)) applies. See Article 3, paragraph (2) of the 1995 Treaty and Article 2, paragraph 2 of the 1968 Treaty.

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(e)(2).¹⁰

The French competent authority has provided us with a breakdown of the manner in which the research credit is either used to offset tax liability or paid in cash to taxpayers (see table above). Of the years in issue, the French government made cash payments of the research credit of between 18.5 percent (17.1% + 1.4% for Year 4) and 26 percent (23.4% + 2.6% for Year 2, and 24.1% + 1.9% for Year 3) of total research credits granted. Our conclusion that the French research credit is not a refund or credit of the foreign tax, as discussed above, might be different if the credit were structured so as to be a refundable amount under French law, but under the law as administered, no cash payments or only de minimis amounts of cash payments were ever granted by the government. The cash payment amounts in this case are by no means de minimis.

Finally, the refund, after the three year deferral, is not substantially less than the present value of a current reduction in French corporate income tax. Furthermore, the French research credit is not restricted to residents of France. Any industrial, commercial, or agricultural taxpayer subject to the French corporate income tax may claim the credit. Accordingly, the refundable French research credit is not a credit within the meaning of Treas. Reg. §1.901-2(e)(2) and does not reduce foreign taxes paid for purposes of determining Taxpayer's foreign tax credit under section 901 of the Code.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

¹⁰ Our conclusion is supported by that reached in GCM 39617 (March 17, 1987).