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subject: Availability of Foreign Tax Credits in Connection with "Participation Interests" in Country X Bonds

This Chief Counsel Advice memorandum responds to your request for advice with respect to claims by Taxpayer for foreign tax credits in connection with “participation interests” in Country X government bonds acquired shortly before their redemption. In accordance with section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Foreign Subsidiary =
Intermediary =
Owner =
Custodian =
Tax or Taxes =
Notes =

Year 3 Notes =

Participation Agreement =

Country X =
Country Y =
Country Z =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Date 1 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
X Percent =

ISSUE 1

Has Taxpayer adequately substantiated its claim for foreign tax credits with respect to the Taxes?

ISSUE 2

Was Foreign Subsidiary legally liable under Treas. Reg. §1.901-2(f) for Taxes imposed on proceeds from the redemption of Notes by virtue of its acquisition of participation interests relating to the Notes approximately three weeks prior to their redemption?

ISSUE 3

Assuming Taxpayer is eligible to claim indirect credits for the Taxes under section 902 or section 960, do the Taxes belong in the separate category for high withholding tax interest as defined in section 904(d)(2)(B)?

CONCLUSION 1

No. Taxpayer bears the burden of substantiating entitlement to foreign tax credits. Notwithstanding numerous requests for such information, Taxpayer failed to provide the necessary information to demonstrate (1) that the Taxes are either creditable income taxes as described in section 901 or taxes "in lieu of" income taxes as described in section 903; (2) how much tax was ultimately owed and paid; and (3) how, under section 902 or 960, such Taxes were deemed paid by Taxpayer on any distributions or inclusions with respect to Foreign Subsidiary. Accordingly, Taxpayer failed to substantiate its entitlement to the claimed foreign tax credits.

CONCLUSION 2

No. Foreign Subsidiary's ownership of the "participation interests" in the Notes fails to establish legal liability for the Taxes as required by Treas. Reg. §1.901-2(f) because Country X law neither imposed a duty to pay the Taxes on Foreign Subsidiary nor viewed Foreign Subsidiary as the owner of the redemption proceeds on which the Taxes were imposed. Therefore, Taxpayer may not claim indirect foreign tax credits with respect to the Taxes.

CONCLUSION 3

Yes. Based on the information provided by Taxpayer, the Taxes would be allocable to the separate category for high withholding tax interest if Taxpayer were eligible to claim a credit for the Taxes. Therefore, Taxpayer's ability to claim credits with respect to the Taxes would be limited to the portion of its pre-credit U.S. income tax liability attributable to its foreign source taxable income in the high withholding tax interest category.

FACTS

Taxpayer claimed foreign tax credits under section 901 in Year 1 through Year 4 with respect to certain Country X Taxes in the aggregate amount of approximately $Amount 1.[1] The Taxes were imposed on proceeds received upon redemption of the Notes, Country X government bonds, which Taxpayer claims were beneficially owned for U.S. tax purposes by its wholly-owned Foreign Subsidiary, a Country Y corporation.

According to Taxpayer, it acquired its interests in the Notes in a series of substantially identical transactions. In one such transaction, Taxpayer represents that Foreign Subsidiary acquired a participation interest in the Year 3 Notes in the following steps.[2] Immediately prior to Date 1, the Year 3 Notes were legally and beneficially owned by Owner, a Country X corporation. The Year 3 Notes bore stated interest of six percent, payable semi-annually. The Year 3 Notes were denominated in Country X currency, but provided that interest and principal would be adjusted to reflect the change in the relative value of the Country X currency and the U.S. dollar. The Year 3

1 Although the bulk of the foreign tax credits were claimed on Taxpayer's U.S. tax return as direct foreign tax credits under section 901, all of the Taxes were purportedly paid on behalf of Foreign Subsidiary with respect to its beneficial ownership of the Year 3 Notes. Upon examination, Taxpayer agreed orally that all such credits must be claimed as indirect credits in accordance with section 902 or 960.

2 Taxpayer agreed that the transactions involving the purported acquisition of the Year 3 Notes were typical of this series of transactions between Years 1 and 4. Taxpayer also indicated that it occasionally deviated from the form of the representative transaction, either by entering participation agreements directly with the legal owner of the Notes or, in some cases, by failing to obtain a guaranty relating to payment of the Notes. Such differences, however, are immaterial to our analysis and conclusions.

Notes were held on behalf of Owner by Custodian, a Country X financial institution, in what Taxpayer represents is analogous to holding securities in “street name.”

On Date 1, approximately three weeks prior to maturity of the Year 3 Notes, Owner entered into a “participation agreement” that purported to transfer “beneficial ownership” in the Year 3 Notes to Intermediary, a Country Z financial institution unrelated to either Owner or Foreign Subsidiary. Although Taxpayer has not furnished a copy of that agreement, Taxpayer represents that it left undisturbed Owner’s legal ownership of the Year 3 Notes, but obligated Owner to pay Intermediary all proceeds from the sale or redemption of the Year 3 Notes remaining after the imposition of the Taxes.

Also on Date 1, Intermediary entered into the Participation Agreement with Foreign Subsidiary which purported to re-transfer the beneficial ownership of the Year 3 Notes to Foreign Subsidiary. The Participation Agreement states that Foreign Subsidiary acquired a ”100 percent participation interest” in the Year 3 Notes and, in return, Foreign Subsidiary agreed to pay Intermediary the excess, if any, of the purchase price ($Amount 5) over the proceeds from the sale or redemption of the Year 3 Notes after the imposition of the Tax. The payment of the purchase price was deferred until the date of redemption of the Year 3 Notes. Taxpayer failed to provide any evidence, however, that it paid Intermediary the amount due.

The Participation Agreement states that Foreign Subsidiary “shall have all rights and powers granted to a legal owner of the [Year 3 Notes]”, but lists only the right to receive any payments from Owner and the right to exercise any of Intermediary’s powers under its agreement with Owner. The Participation Agreement prohibits both parties from assigning their rights and obligations without the prior written consent of the other. In addition, the agreement provides that Intermediary remains liable for any Country X taxes imposed in connection with the Year 3 Notes other than the Taxes. The Participation Agreement contains no provision addressing an interest charge for the deferred purchase price and Taxpayer indicated that the parties never entered any loan or other agreements regarding the transaction other than the guaranty and foreign currency agreement described below.

To provide further assurance that Owner would remit any proceeds from the Year 3 Notes, Taxpayer represents that Intermediary provided Foreign Subsidiary with a guaranty under which it agreed to make Foreign Subsidiary whole for any failure to perform by Owner. The guaranty, however, did not protect Foreign Subsidiary in the event of non-payment by the Country X government on the Year 3 Notes. Similarly, according to the Participation Agreement, Intermediary had “no responsibility with respect to the financial condition of the Obligor [Country X government].”

Taxpayer represented that Owner continued to hold legal title or record ownership of the Year 3 Notes through redemption. Taxpayer also indicated that, to its knowledge, neither the obligor on the Year 3 Notes (the Country X government) nor Custodian was aware that Owner had entered an agreement purporting to transfer beneficial ownership of the Year 3 Notes. Taxpayer further stated that, for Country X tax law purposes, Foreign Subsidiary “has income derived from a derivative, not from the notes.” Therefore, Taxpayer acknowledges that Owner received the redemption proceeds subject to the Taxes for Country X tax purposes.

Also on Date 1, Foreign Subsidiary entered a non-deliverable foreign exchange forward transaction with an affiliate of Intermediary. According to Taxpayer, under this agreement, Foreign Subsidiary “sold U.S. dollars forward for [Country X currency],” which ”effectively converted the [Year 3 Notes] to a [Country X currency] asset, while preserving a U.S. dollar liability.” Taxpayer indicated that the business purpose of this transaction was to enable Foreign Subsidiary “to profit in the event of [Country X currency] strengthening versus U.S. dollar weakening.” The Participation Agreement provided that any payments required under the forward transaction would be taken into account in computing the amount payable by Foreign Subsidiary to Intermediary with respect to the Year 3 Notes. Taxpayer represented that Foreign Subsidiary’s functional currency was Country Y currency in Years 1 and 2 and the U.S. dollar in Years 3 and 4.[3]

Taxpayer represents that the Year 3 Notes were redeemed for Country X currency valued at $Amount 2 and that the Tax withheld from those proceeds equaled $Amount 3, leaving redemption proceeds of $Amount 4. In support of those claims, Taxpayer provided copies of a Country X tax receipt issued in the name of Custodian and showing the tax paid. Taxpayer also provided a copy of a document on Custodian’s letterhead describing the redemption of the Year 3 Notes on behalf of Owner and indicating the same amount of tax paid. Taxpayer indicated that the amount paid at redemption in excess of the purchase price of the Year 3 Notes included both stated interest and original issue discount, but most of the proceeds were attributable to the feature of the Year 3 Notes that required the obligor to increase the proceeds to offset any devaluation of the Country X currency relative to the U.S. dollar. Because, according to Taxpayer, the Country X currency devalued against the dollar by approximately X Percent over the term of the Year 3 Notes, the substantial majority of the redemption proceeds were attributable to the currency devaluation.

Taxpayer takes the position that it acquired a beneficial interest in the Year 3 Notes with a cost basis of $Amount 5 and recognized gross income of $Amount 6 at redemption. However, because the Taxes reduced the redemption proceeds to an amount less than the purchase price, Taxpayer received no cash and was obligated to pay Intermediary $Amount 7.[4] On its Year 3 U.S. tax return, Taxpayer claimed a foreign tax credit of $Amount 3 for the Taxes.

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3 We express no opinion with respect to Taxpayer’s claims concerning the correct functional currency of Foreign Subsidiary during the years at issue, but we have assumed that these representations are correct solely for purposes of this advice memorandum.

4 Taxpayer was also obligated to pay Intermediary approximately $Amount 8 under the foreign exchange forward contract because the Country X currency depreciated against the U.S. dollar during Taxpayer’s three-week holding period.

Taxpayer's representative indicated that the Tax was withheld from the redemption proceeds at a rate of fifteen percent and that the same withholding rate applied regardless of whether the Year 3 Notes were owned by residents or nonresidents of Country X. Despite repeated requests for information from the examination team, Taxpayer has not explained any of the following with respect to the Year 3 Notes and the Taxes: (1) whether the Tax represented a final tax liability or a prepayment of tax calculated on some other basis; (2) how the Tax relates to any income tax otherwise generally imposed by Country X; (3) whether Owner had any income tax liability with respect to the redemption of the Year 3 Notes, taking into account the effect of deductions and losses available to Owner, and, if so, the amount of such liability; and (4) how the Taxes were deemed paid by Taxpayer in accordance with section 902 or 960.

ISSUE 1 – LAW AND ANALYSIS

Subject to applicable limitations, 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 provisions 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 considered 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), (b).

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), -2(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. See Treas. Reg. §1.901-2(e)(1). This requires proof that the tax was remitted to the government and that the payment was not refunded, credited or rebated. Treas. Reg. §1.901-2(e)(2)(i).

Moreover, a credit cannot be claimed with respect to amounts paid that are not owed under a reasonable interpretation of foreign law. Treas. Reg. §1.901-2(e)(5). Where credits are claimed for taxes already paid, the taxpayer must furnish on request a receipt showing that the tax was paid and furnish a certified translation thereof. Treas. Reg. §1.905-2(a)(2).

The taxpayer bears the onus of establishing each of these elements to sustain a claim to foreign tax credits. The courts have long recognized that taxpayers must prove entitlement to the credits they claim. "The 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); see also Treas. Reg. §1.6001-1(a) ("any person subject to tax under subtitle A of the Code . . . shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.").

Despite repeated requests for additional information, Taxpayer's disclosures to date with respect to the Taxes have been minimal and plainly insufficient. Taxpayer has represented that the Tax is withheld at a rate of 15 percent based on the difference between the redemption proceeds and the face amount of the Year 3 Notes. It also represented that the Tax is imposed in a "similar way and in similar amounts" on residents and non-residents. These representations do not approach the minimum information necessary to establish entitlement to the foreign tax credit. In particular, Taxpayer has not provided information on whether the Tax withheld represented a final liability or a prepayment of the taxes ultimately due, how the Taxes related to any income taxes generally imposed by Country X or, in the case of a prepayment, the basis upon which taxes ultimately due are computed. Moreover, Taxpayer was unable to explain why the amount of tax withheld did not equal 15 percent of the amount subject to tax as reflected on the Custodian document memorializing the payment of the Taxes.[5] Without such information, it is impossible to determine whether the Tax represents a separate levy and whether the Taxes meet the standards for creditability under section 901 or 903 and the regulations thereunder.

Taxpayer also failed to introduce any information concerning how much tax, if any, was ultimately owed or paid by Owner with respect to the Year 3 Notes. The production of a tax receipt by Taxpayer associated with the Year 3 Notes is insufficient in this context because Taxpayer refused to indicate whether the Taxes represented a prepayment or final liability for the taxes due with respect to such income. If the Taxes on the receipt represented a prepayment of a liability determined on some other basis,

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5 According to Custodian's record of the Taxes withheld with respect to the Year 3 Notes, the amount of Taxes constituted approximately nineteen percent of the redemption proceeds. When asked to explain this apparent discrepancy, Taxpayer's representative replied that because the tax is based on "net capital gain, coupon interest, and foreign exchange fluctuations . . . the actual percentage withheld will deviate from the normal withholding rate." This response does not illuminate how the Taxes are determined.

only the amount ultimately owed is potentially creditable. Therefore, Taxpayer failed to provide information essential to determine the amount of any foreign tax credit.

Finally, Taxpayer has not provided the information necessary to determine the application of the indirect credit to the amounts at issue. Because the Taxes were purportedly paid on behalf on Foreign Subsidiary, Taxpayer may claim the credits only with respect to the portion of the total post-1986 foreign income taxes paid by Foreign Subsidiary that are attributable to the earnings actually or deemed distributed to Taxpayer. Sections 902 and 960. Taxpayer initially claimed credits for substantially all of the Taxes as if it had directly incurred the Taxes and has disregarded requests for information showing that the credits claimed are consistent with the requirements of section 902 and 960. In sum, Taxpayer has failed to meet its burden of substantiating the credits for the Taxes and no credits are available in the absence of such information.

ISSUE 2 - LAW AND ANALYSIS

Taxpayers are generally permitted to claim a credit for income taxes and taxes “in lieu” of income taxes paid or accrued to a foreign country. Sections 901 and 903. An indirect foreign tax credit is available for creditable foreign taxes paid or accrued by a foreign corporation and deemed paid by a qualifying domestic corporate shareholder upon receipt of a distribution from the foreign corporation. Section 902.

For purposes of the foreign tax credit, the person considered to “pay” a foreign tax is the person on whom foreign law imposes legal liability for the tax. Treas. Reg. §1.901-2(f)(1). This person is the payor of the tax even if another person, such as a withholding agent, actually remits the tax. Id. In addition, this person is the payor of the tax even if another party agrees to assume the tax liability. Treas. Reg. §1.901-2(f)(2).

The legal liability requirement contained in Treas. Reg. §1.901-2(f) follows the Supreme Court’s decision in Biddle v. Commissioner, 302 U.S. 573, 579 (1938). In that case, the Supreme Court held that U.S. principles determine who pays a foreign tax and that, under those principles, the person who is considered to pay the foreign tax is the person on whom foreign law imposes legal liability for the tax. Biddle involved British taxes imposed on the income of, and required to be paid by, British corporations. British law treated the shareholders as paying the tax upon distribution of the income. In determining whether the shareholders “paid” the taxes for foreign tax credit purposes, the Court stated as follows: “That must ultimately be determined by ascertaining from an examination of the manner in which the British tax is laid and collected, what the stockholder has done in conformity to British law and whether it is the substantial equivalent of payment of the tax as those terms are used in our own statute.” Id. at 579. Since the tax was imposed on the corporation and collected from the corporation, the corporation and not the shareholder was the payor of the tax.

When a foreign jurisdiction imposes tax on the income of one person, but assigns the obligation to pay the tax to a second person, the question of who is legally liable for the tax must be resolved to avoid conflicting or duplicative claims to the foreign tax credit. Numerous courts have addressed this issue. The courts have consistently held that the payor of the tax in such cases is the person with the income on which the tax is imposed.

For example, Gleason Works v. Commissioner, 58 T.C. 464 (1972), involved a loan from a United States lender to a British borrower where British law imposed tax on the interest income earned on the loan by the United States lender. Id. at 472. Under British law, the tax was collected from the British borrower, and could not be assessed against or collected from the United States lender. Id. In holding that the United States lender "paid" the tax for purposes of the foreign tax credit, the Tax Court ruled that the "test does not rest upon a search for the person from whom the tax is collectible but rather for the person upon whom the tax is imposed." Id. at 478. The court found the "critical" fact was that the tax was a charge on the interest, and that it was not determinative that the tax could not be assessed against or collected from the United States lender. Id. at 475, 478.

A series of courts reached the same conclusion in a group of cases involving Brazilian taxes on interest paid to United States lenders on loans to Brazilian borrowers. The issue in the cases was whether the United States lender was the person on whom Brazilian law imposed legal liability for the tax and, thus, the person who paid the tax for foreign tax credit purposes. The courts uniformly found that the controlling factor in determining who has legal liability is who has the income on which the tax is imposed. As the United States lenders earned the interest income on which the Brazilian tax was imposed, the lenders were the taxpayers, and the borrowers simply provided a collection mechanism. E.g., Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765, 772-74 (1987); Continental Illinois Corp. v. Commissioner, T.C. Memo 1988-318, aff'd sub nom. Citizens & Southern Corp. v. Commissioner, 919 F.2d 1492 (11th Cir. 1990); aff'd sub nom. Continental Illinois Corp. v. Commissioner, 998 F.2d 513 (7th Cir. 1993), cert. denied, 510 U.S. 1041 (1994).

In sum, the authorities establish that the payor of a tax for foreign tax credit purposes is the person on whom foreign law imposes legal liability for the tax. They establish further that the controlling factor in determining who has legal liability for a foreign tax is who foreign law treats as earning the income on which the foreign tax is imposed and that such person is the payor of the tax even if such person has no obligation to remit the tax to the foreign tax authority. Finally, they establish that a person who is not legally liable for the tax under foreign law cannot claim the credit based on the contractual assumption of the tax liability.

The Taxes for which Taxpayer seeks to claim a credit were imposed on the proceeds from the redemption of the Year 3 Notes. Taxpayer concedes that Foreign Subsidiary was not legally liable for these Taxes under Country X law. In particular, Taxpayer represents that Owner was viewed as the owner of the Year 3 Notes and as receiving the redemption proceeds under Country X law. Taxpayer further represents that Foreign Subsidiary is viewed under Country X law as acquiring a derivative contract from Intermediary.[6] Taxpayer's representations are confirmed by the tax receipt and the Custodian's documents relating to the Taxes. The receipt lists Custodian as the payor of the Taxes and the Custodian's documents show the Taxes as having been paid on behalf of Owner. Furthermore, Foreign Subsidiary is not the party from whom Country X seeks to collect the Taxes on the Year 3 Notes. Foreign Subsidiary had no obligation to pay the Taxes. Nor, as we understand it, could the Country X taxing authority proceed against Foreign Subsidiary in the event Custodian failed to pay the Taxes. Having neither any payment obligation nor the income from the Year 3 Notes under the applicable foreign law, it is clear that Foreign Subsidiary did not have legal liability for the Taxes under Treas. Reg. §1.901-2(f). The execution of contracts that purport to assign the obligation for the Taxes to Foreign Subsidiary is not sufficient to create legal liability for foreign tax credit purposes. Treas. Reg. §1.901-2(f)(2).

We understand Taxpayer's position to be that it is entitled to claim credits for the Taxes because Foreign Subsidiary beneficially owned the Year 3 Notes under U.S. tax principles at the time of the redemption. Even if Taxpayer were able to demonstrate ownership for U.S. tax purposes, this would not enable Taxpayer to claim the credits. Although the existence of legal liability for a foreign tax is ultimately a question of U.S. law, that determination, as described above, is based on how the taxpayer is treated under foreign law – i.e., whether foreign law imposes the levy on the taxpayer. Where, as in this case, Foreign Subsidiary is not viewed under Country X law as earning the redemption proceeds on which the Tax is imposed, Foreign Subsidiary does not have legal liability as required under Treas. Reg. §1.901-2(f). In the absence of such liability, ownership of the Year 3 Notes under U.S. tax principles is insufficient to establish Taxpayer's eligibility to claim a credit for the Taxes.

In this regard, we note that Taxpayer's situation differs from that of the U.S. lenders in Gleason and the Brazilian loan cases. In each of those cases, foreign law considered the U.S. lender to earn the interest income on which the taxes were imposed. Here, Country X does not consider Foreign Subsidiary to earn the income on which the Taxes were imposed.

We also note that Taxpayer's case demonstrates the practical difficulties that would result from the separation of the liability and the credits under Taxpayer's view of the legal liability requirement. As noted above, the foreign tax credit is limited to the amount of creditable tax that is both owed and paid. Treas. Reg. §1.901-2(e)(1), -2(e)(5). Although Taxpayer is attempting to claim the credit, the underlying liability, if any, is owed by Owner and is presumably reflected on its Country X tax return. Accordingly, Taxpayer is not in a position to demonstrate the taxes owed or paid by an unrelated third party with respect to the income from the Year 3 Notes. As discussed

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6 We understand that Foreign Subsidiary filed no tax return and paid no taxes to Country X with respect to its income, if any, with respect to that derivative contract.

above, Taxpayer has repeatedly indicated that it cannot determine the tax owed or paid by Owner.

In any event, we are unpersuaded that Foreign Subsidiary would satisfy the standards for tax ownership under U.S. principles. Ownership of assets for U.S. tax purposes "is a question of fact that must be ascertained from the intentions of the parties as evidenced by the written agreements read in light of attending facts and circumstances." Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). Among the factors considered in such cases are the acquisition of title, how the parties treat the transaction, whether an equity interest is transferred, whether there is a present obligation to make payments, possession of the asset, which party pays the taxes, the risk of loss, and which party receives the profits from ownership and sale of the asset. Id. Most of these factors do not support Taxpayer's position. Foreign Subsidiary deliberately avoided acquiring title to the Year 3 Notes and failed to notify the obligor, the Custodian or the taxing authority of its purported ownership. Nor did Foreign Subsidiary acquire possession of the Year 3 Notes or the right to dispose of the asset it purportedly owned. Payment for the asset was deferred until the date of redemption. Although the Participation Agreement purported to assign the obligation for the Taxes to Foreign Subsidiary, it also provided that Intermediary was responsible for all other Country X taxes. Finally, although Foreign Subsidiary may have had some risk of loss from default and a limited potential for gain or loss from interest rate fluctuations, Taxpayer has not established that any such gain or loss was reasonably expected to be significant given the limited time remaining before redemption of the Year 3 Notes. Under these circumstances, Taxpayer has not established Foreign Subsidiary's ownership of the Year 3 Notes for U.S. income tax purposes.

ISSUE 3 – LAW AND ANALYSIS

Assuming that Foreign Subsidiary had the requisite legal liability for the Taxes and substantiated its claim, Taxpayer's ability to claim credits for the Taxes is further limited by the foreign tax credit limitation under section 904. Under that section, a taxpayer's ability to claim credits for foreign taxes is limited to the taxpayer's pre-credit U.S. income tax liability multiplied by the ratio of the taxpayer's foreign source taxable income to the taxpayer's worldwide taxable income. The limitation is computed separately for several different categories ("baskets") of income. Section 904(d). Accordingly, the amount of credits allowed for taxes allocable to a particular basket is determined by multiplying the taxpayer's pre-credit U.S. tax liability by the ratio of the taxpayer's foreign source taxable income in the applicable basket to the taxpayer's worldwide taxable income.

"High withholding tax interest" is one of the baskets subject to a separate limitation under section 904(d). Section 904(d)(1)(B). High withholding tax interest is defined as any interest subject to a withholding tax imposed by a foreign country . . . at a rate of five percent of more." Section 904(d)(2)(B). A withholding tax for this purpose is any tax imposed on a gross basis. Id.

Treas. Reg. §1.904-6(a) governs the allocation and apportionment of creditable foreign taxes among the baskets of income subject to separate limitations under section 904(d). Under Treas. Reg. §1.904-6(a)(1)(i), the applicable foreign law is first used to determine the income to which foreign taxes relate. Specifically, foreign taxes are related to income if the income is included in the base upon which the tax is imposed. Id. A foreign withholding tax, for example, is related to the income from which it is withheld. Id. Once the taxes are associated with the related income, the taxes are then allocated and apportioned to one or more baskets of income on the basis of how the related income is characterized under U.S. tax principles. For example, if foreign taxes are imposed on income treated as passive income under U.S. principles, then such taxes are allocated to the passive basket. See Treas. Reg. §1.904-6(c), Example (5). Therefore, a tax is allocated to the high withholding tax interest basket where (1) the tax is a withholding tax (i.e., a gross basis tax) imposed at a rate of five percent or more; and (2) the tax relates to income that is interest under U.S. income tax principles.

According to Taxpayer, the Taxes were imposed on a gross basis (i.e., on the difference between the issue price of the Year 3 Notes and proceeds received at redemption) at a rate of fifteen percent. Under Treas. Reg. §1.904-6(a)(1), the Taxes are related to the income from the redemption of the Year 3 Notes because that was the income on which the Taxes were imposed. Therefore, the allocation of the Taxes depends upon the character of that income for U.S. tax purposes.

It is not clear from the facts presented how Taxpayer characterized the Year 3 Notes. It is possible that Taxpayer treated the Year 3 Notes as a synthetic dollar instrument[7] or a contingent payment debt instrument denominated in Country X currency.[8] In either case, Taxpayer presumably treated the redemption proceeds as a combination of principal and interest. If Taxpayer treated the Year 3 Notes as a contingent payment debt instrument denominated in Country X currency, Foreign Subsidiary presumably also reported foreign currency gain (or loss) in connection with the redemption.

In any event, the redemption proceeds constitute a combination of principal and interest under any reasonable method of characterizing the Year 3 Notes for U.S. tax purposes. Therefore, the character of the income for U.S. tax purposes is interest.[9]

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7 We have not considered, and express no views regarding, whether such synthetic treatment is correct for U.S. income tax purposes.

8 Treas. Reg. §1.988-6 would not apply to the Year 3 Notes because it is effective for debt instruments issued on or after October 29, 2004. Treas. Reg. §1.1275-4 would also not apply because the Year 3 Notes, if treated as denominated in Country X currency, would be subject to section 988. See Treas. Reg. §1.1275-4(a)(2)(iv) and section 988(c)(1)(B)(i).

9 Stated interest and original issue discount are both treated as interest for U.S. tax purposes. See Treas. Reg. §1.1272-1(a)(1) ("a holder of a debt instrument includes accrued OID in gross income (as interest)"). Similarly, although no opinion is expressed on whether the participation interests were purchased with market discount, it should be noted that any such discount would have been treated as interest for this purpose. See sections 1276(a)(4) and 1278(b)(1) (market discount "treated as interest

No portion of the Taxes relate to any foreign currency gain recognized with respect to the Year 3 Notes for U.S. tax purposes because such gain is not included in the foreign tax base.

Because the Taxes were a withholding tax imposed at a rate of five percent or more on interest income, the Taxes must be allocated to the high withholding tax interest basket as provided in Treas. Reg. §1.904-6(a)(1). Accordingly, Taxpayer's ability to claim credits with respect to the Taxes is limited to the proportion of its foreign source taxable income in the high withholding tax interest basket to its worldwide taxable income multiplied by its pre-credit U.S. income tax liability.

Please call if you have any further questions.

By: ______________________________
Bethany A. Ingwalson
Senior Counsel, Branch 3
International

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for purposes of this title" except for purposes of sections 103, 871(a), 881, 1441, 1442 and 6049).