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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Paul Epstein
Senior Technical Reviewer
CC:INTL:5

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated May 15, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Country A =
Article A =
Article B =
A =
B =
C =
D =
Product A =
Product B =
Year a =
Year b =
Year c =
Date d =
Date e =
Year f =
Year g =
Amount a =
Amount b =
Amount c =
Amount d =
W% =

X% =
Y% =
Z% =

ISSUES

This Field Service Advice addresses the character and source under the U.S.-Country A income tax treaty of guarantee fees paid by Taxpayer to A, its foreign parent corporation. The following issues are presented:

1) How are guarantee fees paid by Taxpayer in the United States to A in Country A characterized, sourced and subjected to tax under the Internal Revenue Code?

2) Are the guarantee fees characterized as interest under Article A of U.S.-Country A income tax treaty?

3) Are the guarantee fees Industrial and Commercial Profits to A, that are exempt from U.S. tax under the U.S.-Country A Income Tax Treaty?

CONCLUSIONS

1) There is no explicit sourcing rule for guarantee fees. Guarantees must instead be sourced by analogy to the closest enumerated income item. Interest income is the closest such item. Under section 861(a)(1), interest paid by a U.S. corporation, such as taxpayer, generally is treated as income from sources within the United States. Although the fees are sourced like interest, they are not characterized as interest, because they are not payments for the use or forbearance of money. Accordingly, guarantee fees are other FDAP potentially subject to tax at the rate of 30%.

2) The guarantee fees are not interest within the meaning of Article A of the U.S.-Country A treaty. The payments constitute “other income” taxable at the full U.S. statutory rate of 30 percent unless sufficient facts establish that the payments constitute industrial and commercial profits to A.

3) Based on the facts submitted, we do not have sufficient information to conclude whether the guarantee fees constitute industrial and commercial profits under the U.S.-Country A treaty.

FACTS

In Year a, A formed a wholly owned U.S. subsidiary, B, to engage in buying, selling, and leasing Product A. In Year b, A split B's business into two parts. B was to concentrate on the loan business, and C was formed to lease and sell Product A. Also in Year b, C decided to cancel all future purchases of Product A due to poor business. C owned eight Product A at the time of cancellation. It was able to sell one of the Product A at a loss, but Taxpayer claims C had difficulty leasing or selling the remaining seven Product A because it was unable to obtain low interest rate financing due to its accumulated losses.

In Year c, A formed a new U.S. subsidiary, D, later renamed as Taxpayer's current name. A caused C to sell the seven Product A to Taxpayer in Date d for Amount a, which was the outstanding total indebtedness of C in connection with the Product A purchases. C had previously entered into loan agreements with various domestic subsidiaries of A. Taxpayer assumed C's loans payable to these affiliates of Amount b and accrued interest payable of Amount c.

Taxpayer states that the related corporations raised the funds for the loans from third party lenders. To assure these third party lenders that Taxpayer would meet its payment obligations under the loans, Taxpayer and A entered into a guarantee agreement as of Date e. Article 1 of the agreement provided that A would negotiate the terms of the loan agreement with the lenders on Taxpayer's behalf and would unconditionally guarantee Taxpayer's performance under the loan agreements. Articles 2 and 3 of the agreement provided that Taxpayer would pay A a guarantee fee of W% per annum (in dollars) of the average outstanding debt each quarter. Taxpayer paid these guarantee fees to A without withholding any U.S. tax. During Year f, Taxpayer paid A guarantee fees of Amount d. On its Year f U.S. income tax return, Taxpayer characterized the guarantee fees as consideration for A's performance of personal services. Consequently, Taxpayer treated the guarantee fees as foreign source income not subject to U.S. taxation.

Taxpayer asserts that A actively conducted a leasing and loan business with both related and unrelated parties, with the majority of A's business conducted with unrelated parties. In support of this claim, A has provided a nonconsolidated financial statement for Year f and Year g purporting to show that X percent of A's assets consisted of commercial loans to third parties. During the Date f taxable year, A held guarantees relating to companies that use Product A and Product B. Typically, A received guarantee fees of Y percent to Z percent for its guarantee of unrelated party debt and charged a guarantee fee of W percent to related parties.

LAW AND ANALYSIS

I Tax treatment of the guarantee fees under the Internal Revenue Code

A. *Characterization and sourcing of guarantee fees*

Taxpayer characterized the guarantee fees as remuneration for personal services performed by A outside the United States and consequently sourced the payments as foreign and exempt from U.S. tax under the Internal Revenue Code ("the Code"). The transaction as described, however, is a guarantee extended by A for the financial performance of Taxpayer, not for the initial negotiation of Taxpayer's borrowings from unrelated third parties. Since no service was documented or apparently remunerated for a purported negotiation function, we conclude that the guarantee fees are remuneration solely for the value of the guarantee.

This conclusion is supported by the case law. In Bank of America v. U.S., 680 F.2d 142 (Ct. Cl. 1982), the court addressed how to source commissions which the taxpayer bank had received from foreign banks relating to export letters of credit issued by foreign banks. The taxpayer had received confirmation and acceptance commissions from the banks for its assumption of credit risk it extended to the foreign banks to guarantee the full amount the taxpayer owed to U.S. exporters under the letters of credit. Thus, such letters of credit are the functional equivalent of the Taxpayer's guarantees.

In Bank of America, the court did not find that the taxpayer's activities relating to earning the acceptance and confirmation commissions were sufficient to characterize the commissions as compensation for the performance of services. Id. Instead, the court considered the activities involved in extending the letters of credit as ancillary to the true substance of the transactions, which was the substitution of the taxpayer's credit for that of the foreign banks. Id. Similarly, in Centel Communications Co., Inc. v. Commissioner, 92 T.C. 612 (1989), *aff'd.* 920 F.2d 1335 (7th Cir. 1990), the Tax Court found that guarantees issued by shareholders in a corporation were not characterized as the performance of services under section 83 of the Code.

The court recognized that there is no explicit statutory or regulatory sourcing rule for guarantees under sections 861, 862, and 863 of the Code.[1] The court stated:

> When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes. *E.g.*, *Howkins v. Commissioner*, 49 T.C. 689 (1968).

[1] Section 865 (covering source rules for sales of personal property) was added to the Code for years beginning after 1986, and also does not provide a specific source rule for the treatment of guarantee fee income.

Bank of America, at 147.

The court found that the acceptance commissions received by the taxpayer were analogous to interest because the commissions compensated the taxpayer for the credit risk and credit administration attendant with guaranteeing payment under the letters of credit in a manner similar to how interest compensates credit risk and credit function. Id. at 149. Because the closest statutory sourcing provisions by analogy were those related to interest, the court found that the acceptance and confirmation commissions should be sourced under sections 861(a)(1) and 862(a)(1) of the Code. Id.

Applying Bank of America and Centel Communications to this case, we conclude the guarantee fees paid by Taxpayer are not characterized under U.S. principles as services and should be sourced by analogy to payments of interest. As in Bank of America and Centel Communications, the terms of the transactions demonstrate that the guarantee fees were primarily intended to compensate A for its substitution of its credit risk rather than to compensate A for the purported performance of any services including any activities relating to the extension of the guarantees.

B. *Application of Source and FDAP provisions to Taxpayer's guarantee fees*

Under section 861(a)(1) of the Code, interest paid by a domestic corporation is treated as from sources within the United States unless excepted under this provision. Taxpayer is a domestic corporation that has not demonstrated it meets any of the exceptions to U.S. sourcing delineated in section 861(a)(1). In particular, Taxpayer has provided no evidence that it meets the foreign business requirements of section 861(c) which could cause some measure of interest payments made to related parties to be treated as foreign source. Accordingly, under the general rule of section 861(a)(1), the guarantee fees paid by Taxpayer to A should be treated as U.S. source.

Section 881(a)(1) of the Code provides, generally, that a foreign corporation is subject to a 30-percent tax on amounts received from sources within the United States as interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States. Amounts for which tax may be imposed under section 881(a)(1) are generally subject to withholding at source under section 1442(a).

If A is not engaged in the active conduct of a trade or business within the United States, any U.S. source income that it earns would not be considered

income effectively connected with a U.S. trade or business. As stated above, the guarantee fees do not constitute interest. Consequently, such income would be subject to gross basis taxation under section 881(a) of the Code, not as interest, but as other fixed, determinable, annual or periodic ("FDAP") income. Therefore, the payment is characterized as other FDAP income from sources within the United States, subject to tax at 30 percent on the gross amount under sections 881(a) and 1442 of the Code.

II Whether Article A (Interest) of the treaty applies to the payment of a guarantee fee

Article A defines interest for purposes of the treaty as

> [i]ncome from bonds, debentures, Government securities, notes or other evidences of indebtedness, whether or not secured, and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income assimilated to income from money lent by the taxation law of the Contracting State in which the income has its source.

The guarantee fees will constitute interest within the meaning of the treaty only if the fees are "income assimilated to income from money lent" because the fees do not fall within any of the other terms enumerated in the Article A definition. The term "assimilated to" means "treated as." This interpretation finds clear support in the Explanation to the 1963 OECD Draft Double Taxation Convention on Income and Capital. Paragraph 25 of the OECD Commentary to Article 11 explains the phrase "income assimilated to income from money lent" as follows:

> In any case, the Article does not give a complete and exhaustive list of the various kinds of interest. Such a list might not be fully in harmony with the various States' laws, which may differ among themselves in their interpretation of the concept of interest. It therefore seems preferable to include in a general formula all income which is assimilated by those laws to remuneration on money lent. This applies in particular to interest derived from cash deposits and security lodged in money.

Guarantee fees are not income assimilated to income from money lent for purposes of the treaty because guarantee fees are not treated as remuneration on money lent for federal income tax purposes. *See also* Deputy v. Dupont, 308 U.S. 488, 497-98 (1941); Technical Explanation of the Tax Treaty between the United States and the United Kingdom, 1980-1 C.B. 955, 965 (identifying original issue discount as an item assimilated to income from money lent). Therefore, the guarantee fees cannot properly be treated as interest for purposes of the treaty.

Some United States income tax treaties include an “Other Income” article which serves as a catchall provision to cover items or classes of income not otherwise covered by the treaty. These articles frequently permit only the country of residence to tax such items or classes of income. The United States - Country A Income Tax Treaty contains no such provision. Thus, as discussed above, if the income is not exempt from tax under Article B, as discussed below, A is subject to a 30-percent tax on the gross amount of the payments under section 881(a) of the Code.

III Whether Article B, (Business Profits), of the Treaty acts to exempt the transfer from taxation by the United States as “commercial or industrial profits.”

Taxpayer contends that even if the guarantee fees it paid A are U.S. source FDAP under the U.S. internal law, such income, nevertheless, is not subject to taxation in the United States because the income is earned in connection with the active conduct of A’s business and, thus, constitutes “commercial and industrial profits” under the Article B of the treaty that are not attributable to a permanent establishment of A within the United States.

We currently do not have sufficient facts to determine whether A’s guarantees were entered into as part of the active conduct, by A, of a lease financing business. Thus, further factual development is necessary to determine whether Taxpayer’s activities may be exempt from U.S. taxation under Article B of the treaty.

We recommend that further facts be developed to determine:

1) The scope and regularity of A’s activity of providing guarantees on financing deals and whether such guarantees are limited to transactions with related parties or were also entered into with unrelated parties;

2) The scope of A’s overall financing activities for the years under examination and whether its leasing activities involved finance leases and extensions of credit under U.S. tax principles or whether A’s trade or business involved non-financing lease activities;

3) Whether the guarantees on Taxpayer’s debt were made out of A’s trade or business of providing financial guarantees and whether such guarantees were made out of a finance leasing trade or business or were made independently of such activities, if any.

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Please call 202-622-3870 if you have any further questions.

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