Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 200532044

Release Date: 8/12/2005

CC:INTL:B03:RLChewning
POSTF-112106-05

UILC: 901.02-00

date: May 05, 2005

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(Large & Mid-Size Business)

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Chief, CC:INTL:Br3

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subject: Compulsory Payment--Exhaustion of Administrative Remedies

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

LEGEND

Sub	=
Taxpayer	=
Country X	=
Country Y	=
DE	=
Year A	=
Year B	=
Year C	=
Tax Law	=
Date D	=
Date E	=
Date F	=
Amount N	=
Amount O	=
Amount P	=
Amount Q	=
Amount R	=

Amount S =

ISSUES

1. Whether Sub, a dual-resident company under the U.S.-Country X income tax treaty (the "Treaty"), is obligated to request, pursuant to Article ( ) (Residence) of the Treaty, that the competent authorities resolve by mutual agreement whether Sub is solely a resident of one of the two states in order to determine whether Sub's payment of tax to Country X on bank interest arising in Country Y is a compulsory payment within the meaning of Treas. Reg. §1.901-2(e)(5).

2. Alternatively, even if it is determined that Sub's payment of Country X tax was a compulsory payment, whether the imputation credits received by the holders of a hybrid instrument issued by DE, Sub's Country X parent, were subsidies under section 901(i) so that Sub's payments of Country X tax will not be considered an amount of income tax paid or accrued.

CONCLUSIONS

1. Yes. Sub is required to request that the competent authorities resolve its country of residence before it will be considered to have exhausted all effective and practical remedies to reduce its liability for Country X tax with respect to the interest income received from the Country Y bank. If an agreement can be reached on its residence, Article (Other Income) of the Treaty would allocate taxing rights solely to the country of residence with respect to that income. Since, on the facts of this case, it is reasonable to expect that the competent authorities would agree that Sub is solely a resident of the United States for purposes of the Treaty, Sub's failure to seek competent authority resolution of the issue of residency constitutes a failure to exhaust all effective and practical remedies to reduce its liability for Country X tax. Accordingly, Sub's payments of Country X tax attributable to the Country Y interest income are not compulsory payments under Treas. Reg. §1.901-2(e)(5) and, therefore, are not treated as payments of creditable foreign income taxes.

2. If the payments made by Sub attributable to the Country Y interest income were compulsory, the Service should not seek to disallow the credit on the ground that imputation credits allowed by Country X to the holders of the hybrid instruments issued by DE constitute a subsidy within the meaning of section 901(i).

FACTS

In Year A, as part of a U.S.-Country Y cross-border, sale/leaseback transaction, Sub deposited funds equal to the present value of the Taxpayer's consolidated group's future lease obligations under the transaction in an interest-bearing account in a bank in Country Y. Sub, a company incorporated in the United States, is an indirect, wholly-owned subsidiary of Taxpayer and was included in Taxpayer's consolidated return for Years B and C.

In Year B, in order to increase the yield on Sub's deposit in the Country Y bank, Taxpayer's consolidated group entered into a multi-step financing transaction to convert the yield on the deposit into a fixed rate of interest denominated in Country X currency ("Financing Transaction"). As part of that Financing Transaction, Sub became a subsidiary of DE, a Country X corporation that is a subsidiary of a domestic subsidiary of Taxpayer. DE, which was created as part of the Financing Transaction, is treated as a corporation for Country X tax purposes and as a disregarded entity for U.S. tax purposes.

As part of the Financing Transaction, DE issued hybrid instruments that were purchased by newly-formed Country X corporations that were owned by unrelated third-party investors.

those hybrid instruments were considered equity for Country X tax purposes. Accordingly, payments made by DE to the Country X corporations under the hybrid instruments were treated as dividends for Country X tax purposes, entitling the corporations to imputation tax credits. Under section of the Country X Tax Law, the imputation credits were based on the Country X tax paid by DE, the company paying the dividends. If the imputation credits exceeded a taxpayer's Country X tax owed for the year in which it received the dividend, the excess was not refundable in cash, but the taxpayer could claim a loss deduction for the excess amount in a later year.

At the same time as the Financing Transaction, Sub appointed Country X directors to its board so that the Country X directors would be the majority of the directors of the board.
Sub would be treated as a resident of Country X under Section of the Country X Tax Law.[1] contingent upon Country X directors continuing to constitute a majority of Sub's directors in meetings held by telephone or upon directors' meetings being held in Country X.

In a ruling on Date D, the Country X tax authorities approved DE's and Sub's application to file a consolidated income tax return. The Country X tax authorities in its ruling issued on Date F affirmed DE's and Sub's entitlement to file a consolidated income tax return but made that entitlement contingent upon Sub not being considered a nonresident of Country X under a tax treaty. The Date F ruling also authorized the two companies to maintain a consolidated imputation account which comprised the Country X tax paid by the consolidated group. Consolidation was necessary as part of the

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[1]

Financing Transaction in order for the Country X tax paid on the interest received by Sub on the Country Y bank deposit to be claimed as an imputation credit by the hybrid instrument holders that were treated as shareholders of DE for Country X tax purposes.

For Years B and C, Sub and DE filed consolidated Country X income tax returns and paid Country X income tax in Amount N and Amount O, respectively. Included in income on those consolidated returns were the following reportable income and expense amounts, expressed in Country X currency:

Income/expense Item	Year B	Year C
a. Interest from Country Y bank	Amount P	Amount Q
b.		
c.		
d.		
e.		
Total		

All of the income items were paid by nonresidents of Country X. Only the first item, interest from the Country Y bank, was income earned by Sub. Items b through e were earned, or were expenses incurred, by DE.

Sub is a resident of the United States under the Treaty because its place of incorporation is in the United States, and we understand that Sub is also a resident of Country X under the Treaty, apparently because Sub's place of management is located in Country X according to Country X law. The -member Board of Directors includes members who are residents of Country X, and meetings are conducted by telephone or in Country X. Sub has not requested, pursuant to paragraph of Article (Residence) of the Treaty, competent authority relief to determine that it is solely a resident of the United States, its country of incorporation, under the Treaty and therefore, is not subject to Country X tax on the interest paid to it by the Country Y bank (item a. in the above table). Correspondence between Sub's Country X representative and the Country X tax authorities demonstrates that Sub was well-aware of competent authority procedures for resolving issues of dual residency and that Sub does not intend to seek competent authority resolution of the residency issue. For purposes of the Financing Transaction, Sub chose to subject itself to double taxation on the Country Y interest payments by becoming a resident of Country X according to that country's domestic law.

On its Year B and Year C U.S. income tax returns, Taxpayer reported interest income received by Sub on its deposits in the Country Y bank of Amount R and Amount S, respectively, along with items of income and expense incurred by DE. Taxpayer claimed foreign tax credits with respect to the taxes paid to Country X by the Sub-DE consolidated group of Amount N and Amount O for Year B and Year C, respectively.

LAW AND ANALYSIS

Section 901 of the Code allows a foreign tax credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." A foreign levy is an income tax if and only if: (1) it is a tax; and (2) the predominant character of that tax is that of an income tax in the U.S. sense. Treas. Reg. §1.901-2(a)(1). A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Treas. Reg. §1.901-2(a)(2)(i) and (e)(5). A foreign tax credit is allowed only for the amount of income tax that is both owed and paid to a foreign country by the taxpayer. Section 901(b)(1) and Treas. Reg. §1.901-2(a)(1) and (e).

1. Compulsory Payment Requirement Issue

A foreign levy is a tax that may be claimed as a foreign tax credit under section 901 if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Treas. Reg. §1.901-2(e)(5)(i) provides as follows:

> An 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. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). . . . . In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success.

The issue in this case is whether Sub was required to request that the competent authorities resolve its dual-resident status pursuant to Article ( ) (Residence) of the Treaty in order to satisfy the requirement that it invoke competent authority procedures available under the Treaty that might reasonably be expected to result in a reduction in

Sub's liability for Country X tax with respect to income earned by Sub from a Country Y bank account.

The residence of a company is determined under Article (Residence) of the Treaty. Paragraph of Article (Residence) defines the term "resident", in part, as any person who, under the laws of a contracting state, is taxable therein by reason of domicile, residence, place of management, place of incorporation, or any other similar criterion.

Sub is a resident of the United States under the Treaty because its place of incorporation is in the United States, and we understand that Sub is also a resident of Country X under the Treaty, apparently because Sub's place of management is located in Country X according to Country X law. The -member Board of Directors includes members who are residents of Country X, and meetings are conducted by telephone or in Country X.

Article ( ) (Residence) of the Treaty provides that when a corporate taxpayer is a resident of both contracting states, the competent authorities will attempt to settle by mutual agreement the issue of whether the corporation will be considered a resident solely of one of the states. If they are unable to agree, the corporation will be considered a resident of neither state for purposes of the Treaty.

The procedure for obtaining a mutual agreement is contained in Article (Mutual Agreement Procedure) of the Treaty. A request for assistance under Article (Mutual Agreement Procedure) must be presented to the competent authority within years from the first notification that the actions of one or both of the contracting states result or will result in double taxation. *See* Article ( ) (Mutual Agreement Procedure). This period of limitations would commence to run from the date Taxpayer first receives notification that its claim of foreign tax credits will be denied.

If the competent authorities agreed that Sub was solely a resident of the United States for purposes of Article ( ) (Residence), taxing rights with respect to the Country Y interest income would be resolved in favor of the United States under Article (Other Income), which provides:

The correspondence available to us between Sub's Country X representative and the Country X tax authorities, as detailed above, shows that Sub was aware that competent authority procedures were available to resolve issues of dual residency. Had Sub availed itself of those procedures, Sub might reasonably have expected to avoid Country X tax on the interest from the Country Y bank account. For purposes of the Financing Transaction, however, Sub chose to subject itself to double taxation on the

Country Y interest payments by becoming a resident of Country X according to that country's domestic law and affirming its intent not to avail itself of the competent authority procedures. An amount paid to Country X is not a compulsory payment (and may not be claimed as a foreign tax credit) to the extent it exceeds the amount of tax liability determined under Country X law. The amount paid does not exceed the amount of such tax liability if, among other things, the taxpayer invokes competent authority procedures available under the applicable treaty in an effort to reduce such liability.

The Treaty provided Sub with the opportunity to resolve its dual-resident status and the attendant exposure to double taxation, but Sub chose not to seek relief. Instead, after taking specific steps designed to create a Country X tax residence, Sub engaged in correspondence with Country X tax authorities and tried to counter any suggestion that Sub's Country X tax liability might be avoided.

The regulations under section 901 require a taxpayer to "exhaust all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax ...." In this case, the approach taken by Taxpayer did not satisfy this standard.

2. Tax Paid-Subsidy Issue

A foreign tax credit is allowed only for the amount of income tax that is paid to a foreign country by the taxpayer. Section 901(b)(1) and Treas. Reg. §1.901-2(a)(1) and (e)(1). An amount paid is not treated as a tax if the amount is used (directly or indirectly) by the country imposing the tax to provide a subsidy to the taxpayer, a related person, or any party to the transaction or to a related transaction, provided that the subsidy is determined (directly or indirectly) by reference to the amount of that tax, or the base used to compute the amount of that tax. Section 901(i) and Treas. Reg. § 1.901-2(e)(3). Treas. Reg. §1.901-2(e)(3)(i)(A) provides that a subsidy may be provided by any means, including a credit. Substance, and not form, controls in determining whether a subsidy exists. Treas. Reg. §1.901-2(e)(3)(ii).

The House of Representatives Committee on Ways and Means in H. Rept. 99-426, at 351 (1985), 1986-3 C.B. (Vol.2) 1, 351, explained the reason for the enactment of section 901(i) as follows:

> As indicated above, a Treasury regulation denies a foreign tax credit for foreign taxes used directly or indirectly as a subsidy to the taxpayer. Absent this rule, the U.S. Treasury would, in effect, bear the cost of tax subsidy programs instituted by foreign countries for the direct or indirect benefit of their residents and certain nonresidents who do business with their residents. The committee is informed that some U.S. lenders and other U.S. taxpayers take tax return positions that are inconsistent with this rule. The committee does not believe that foreign tax credits should be allowed for foreign taxes which, while ostensibly imposed, are effectively rebated by the levying country by means of a government subsidy to the taxpayer, a related party, or a party to a transaction

> with the taxpayer. To eliminate any uncertainty in this area, the committee believes that the Treasury regulation disallowing foreign tax credits for taxes used as a subsidy to the taxpayer should be codified.

Under Country X law, the Country X corporations that purchased the DE hybrid instruments as part of the Financing Transaction received a non-refundable imputation credit based upon the amount of tax paid by the DE-Sub consolidated group. However, in our view, the Service should not argue that the imputation credit constitutes a subsidy under section 901(i)(1) and Treas. Reg. §1.901-2(e)(3), so long as the tax paid by the DE-Sub consolidated group is retained by Country X. Under the Country X imputation credit system, a tax, albeit a single level tax, is paid to and retained by Country X. Thus, this is not a situation identified in the House Report involving a tax that is "ostensibly imposed, [but] effectively rebated by the levying country by means of a government subsidy to the taxpayer, a related party, or a party to a transaction with the taxpayer." While Treas. Reg. §1.901-2(e)(3) provides that a subsidy may take the form of a credit, courts have held that a tax credit allowed to a related party does not constitute a subsidy if the original tax payment on which the related party tax credit is based is retained by the foreign taxing authority. *See Compaq Computer Corporation v. Commissioner*, 113 T.C. 363 (1999). Accordingly, we recommend against raising this issue.

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