Office of Chief Counsel
Internal Revenue Service

memorandum

Number: **20032401F**
Release Date: 6/13/2003
CC:LM:FS:LI:POSTF-129710-02

date: May 5, 2003

to: Cary Allen, Technical Advisor, Leasing Technical IP
Patricia Autry, Technical Advisor, Leasing Technical IP

from: Jody Tancer, Associate Area Counsel
(Financial Services:)

---

subject: **Foreign Tax Credit Implications in Ownership-FSC Transactions**
UIL 245.04-00, 245.05-00, 245.09-00, 861.02-00, 862.00-00, 901.01-00, 902.02-00, 902.03-16, 902.03-21, 902.03-22, 902.03-24, 902.04-00, 904.03-08, 906.30-00, 921.00-00, 923.00-00, 924.01-00

On August 14, 2002, we sent you a memorandum (the earlier memorandum), analyzing whether treating an Ownership-FSC (O-FSC) transaction entered into by a domestic financial services institution (the parent/taxpayer)and its Foreign Sales Corporation (TP-FSC) as a financing arrangement would increase available foreign tax credit (FTC). The Office of the Associate Chief Counsel (International), provided us with comments on the earlier memorandum. As a result of those comments, this memorandum reflects the modifications suggested by the National Office. This memorandum should not be cited as precedent.

ISSUES

1. Whether rental income received by TP-FSC in an O-FSC leasing transaction that is recharacterized as interest income from a financing arrangement is income effectively connected with the conduct of a trade or business within the United States (ECI)?

2. Whether TP-FSC may claim a FTC with respect to such recharacterized interest income?

3. Whether parent/taxpayer may claim a deemed paid FTC with respect to such recharacterized interest income?

4. Whether parent/taxpayer’s FTC limitation will increase as a result of such recharacterization?

CONCLUSIONS

1. Rental income received by TP-FSC in an O-FSC leasing transaction recharacterized as interest income from a financing transaction is ECI.

2. TP-FSC may claim a FTC with respect to such recharacterized interest income.

3. Parent/taxpayer may not claim a deemed paid FTC with respect to such recharacterized interest income.

4. The parent/taxpayer's FTC limitation may increase as a result of this recharacterization of income.

FACTS

The facts below are taken solely from one of the parent/taxpayer's O-FSC transactions that was the subject of prior Field Service Advice.

Please note that for purposes of this memorandum, we will use "parent/taxpayer" to include the domestic financial services institution, its subsidiaries, and various entities that parent/taxpayer has acquired, but the term does not include TP-FSC or any other FSC.

In this transaction, treated as a sale/leaseback by the parties, TP-FSC was incorporated in as an indirectly wholly owned subsidiary of the parent/taxpayer. In addition to TP-FSC, parent/taxpayer established a wholly owned domestic Grantor Trust (the Trust) which functioned as the vehicle for the establishment, capitalization, and maintenance of TP-FSC. The Trust owned 100 percent of TP-FSC's outstanding stock. Per the transaction as created by the participants, a second domestic Grantor Trust (Trustee) was the borrower of the nonrecourse loan from the Foreign Lender; the Trustee was authorized by the parent/taxpayer to act as Trustee for the first Trust and to hold the capital stock of TP-FSC. The Trustee transferred funds from the parent/taxpayer via the Trust (the equity investment) and the total proceeds of the nonrecourse loan to TP-FSC.

As required by the Loan Agreement, TP-FSC used the nonrecourse loan proceeds and the equity investment to allegedly purchase the subject to this O-FSC transaction. However, TP-FSC did not obtain actual title to the .

Immediately after purchasing the , TP-FSC leased it to a subsidiary of the foreign Tax Exempt Entity. Rent from the foreign Tax Exempt Entity, paid per a basic rent schedule, was deposited in TP-FSC's account in a bank. In addition, per the Tax Indemnity Agreement, TP-FSC agreed to distribute all rent payments to the parent/taxpayer immediately upon receipt. Further, in connection with the Equity Collateral, TP-FSC was the recipient of payments due under certain of the Notes.

We understand that the parent/taxpayer and TP-FSC treated the O-FSC transaction as follows for tax purposes[1]:

1. TP-FSC reported rental income from the foreign Tax Exempt Entity.

2. TP-FSC claimed depreciation on the and amortized its transaction costs.

3. TP-FSC's foreign trade income was determined using a nonadministrative pricing method.

4. Of the foreign trade income, 30 percent was treated as nontaxable exempt foreign trade income.

5. The remaining 70 percent of the foreign trade income was treated as income[2] not effectively connected with a U.S. trade or business and therefore as not subject to Federal income tax.

6. The foreign trade income was transferred to the Trustee, which then distributed it to the parent/taxpayer.

7. On its consolidated return, parent/taxpayer claimed a 100 percent dividend received deduction (DRD) with respect to distributions from TP-FSC attributable to exempt foreign trade income (FTI).

8. On its consolidated return, parent/taxpayer claimed an

---

[1] Please note that we have not reviewed any of TP-FSC's or the parent/taxpayer's income tax returns.

[2] Please note that an analysis of whether any of TP-FSC's income constituted income is beyond the scope of this memorandum. We assume for purposes of this memorandum that the recharacterized interest income does not constitute income.

interest expense deduction with respect to the nonrecourse loan, thus offsetting the distribution attributable to TP-FSC's non-exempt FTI.

ANALYSIS

Based on the facts of this case, we understand that the National Office supports the recharacterization of this purported sale/leaseback as a financing arrangement. Thus, for purposes of this memorandum, we treat the "lease" income as interest income.[3]

Issue 1: Is the income received by TP-FSC from the foreign Tax Exempt Entity in this O-FSC transaction ECI?

Internal Revenue Code § 923(b) defines "foreign trade income" as the gross income of a FSC attributable to foreign trade gross receipts (FTGR). Internal Revenue Code § 924(f)(2) specifically provides that the term "foreign trading gross receipts" shall not include investment income. And, Internal Revenue Code § 927(c) defines investment income as including interest. Thus, once this O-FSC transaction is recharacterized as a financing arrangement, the income earned by TP-FSC would constitute investment income, which cannot give rise to FTI (whether exempt or non-exempt). Interest income earned by a FSC is subject to the rules in Internal Revenue Code § 921(d).

Section 921(d)(2) states that all interest income received or accrued by a FSC shall be treated as ECI. See also Treas. Reg. § 1.921-2, Q-8 and Q-9. Accordingly, the interest income received by TP-FSC in this O-FSC transaction is includible in its taxable income subject to federal income tax; see the above regulation, Q-10. In contrast, 70 percent of the income received by TP-FSC from the Tax Exempt Entity would be ECI if the income retained its character as rental income.

Issue 2: Is TP-FSC entitled to a FTC with respect to such recharacterized interest income?

Internal Revenue Code § 27 provides that the amount of taxes imposed by foreign countries shall be allowed as a credit to the extent provided in Internal Revenue Code § 901. In turn,

---

[3] Please note that some portion of the recharacterized interest payments may be properly characterized as principal or as original issue discount income. This memorandum will not further discuss any such characterization or any allocation of the payments.

§ 901(a) states that the tax imposed by this chapter shall, subject to the limitation of Internal Revenue Code § 904, be credited with the amounts provided in the applicable paragraph of subsection (b). Section 901(b)(4) provides that in the case of a foreign corporation, the amount allowed as a credit must be determined under § 906. Section 906(a) allows a foreign corporation engaged in a trade or business within the United States a credit under § 901 for the amount of any income taxes paid during the taxable year to any foreign country with respect to ECI.

In addition, § 906(b)(5) provides that no credit shall be allowed for income tax paid or accrued with respect to a FSC's foreign trade income, within the meaning of Internal Revenue Code § 923(b). Because TP-FSC's interest income is foreign source and is not FTI, TP-FSC will be entitled to a FTC for foreign taxes paid with respect to the interest income that, as discussed, is ECI. Moreover, Treas. Reg. § 1.921-3T(d) pertains to credits against tax and provides in subparagraph (d)(2)(i) that the direct foreign tax credit of § 901(b)(4) as determined under Internal Revenue Code § 906 for income taxes paid or accrued to any foreign country is allowed only to the extent that those taxes are attributable to the FSC's foreign source non-foreign trade income effectively connected with its conduct of a trade or business within the United States. Treas. Reg. § 1.921-2(Q & A 10) provides that the source of interest income will be determined under Internal Revenue Code §§ 861, 862, and 863. Here, because the payor of the interest is a non-resident, the interest income is foreign source under § 862(a)(1).

Of course, in order for TP-FSC to be entitled to its direct FTC under §§ 901 and 906, it must have paid income tax to a foreign country. Although we assume for purposes of this memorandum that tax has been paid to , we have no knowledge of any such payment. Accordingly, TP-FSC is entitled to a FTC only to the extent it paid taxes to . In contrast, no FTC would be available to TP-FSC if the income retained its character as rental income because rental income would qualify as FTI. Further, Treas. Reg. § 1.921-3T(d)(2)(ii) provides that the FTC for domestic corporate shareholders in foreign corporations provided under § 901(a) as determined under Internal Revenue Code § 902 is allowed for income taxes deemed paid or accrued by a FSC only to the extent those taxes are deemed paid or accrued with respect to the FSC's § 923(a)(2) non-exempt income and its non-foreign income (here, TP-FSC's interest income).

Issue 3: Is parent/taxpayer entitled to a deemed paid FTC with respect to such recharacterized interest income?

We assume that parent/taxpayer is not subject to foreign income tax with respect to TP-FSC's interest income and, therefore, would not be entitled to a direct FTC under § 901(b)(1). The question remains whether parent/taxpayer may be entitled to a deemed paid FTC under § 902. Section 902(a) provides that a domestic corporation owning 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid a portion of such foreign corporation's income taxes. Since parent/taxpayer owns 100 percent of TP-FSC, this provision applies here.

However, § 906(b)(6) provides that, for purposes of § 902, any income taxes paid or accrued, or deemed paid or accrued, to any foreign country with respect to ECI shall not be taken into account. Since we concluded above that the recharacterized interest income here would be ECI, under § 906(b)(6) the parent/taxpayer would not be entitled to a deemed paid FTC under § 902.

Issue 4: Will parent/taxpayer's FTC limitation increase as a result of the above recharacterization of income?

Under § 904(a), the total amount of the credit taken under § 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. Based on Internal Revenue Code §§ 861(a)(1) and 862(a)(1) [4] and the regulations thereunder, the interest received from the foreign Tax Exempt Entity in this O-FSC transaction would not be U.S. source income because: (1) it was not interest paid by the United States or any agency/instrumentality thereof; (2) it was not interest paid by a resident of the United States since this Tax Exempt Entity, to our knowledge, did not qualify as a foreign corporation or partnership engaged in a trade or business within the United

[4] Section 861(a)(1) states that interest income shall be treated as income from sources within the United States when it is interest income from the United States or the District of Columbia, or interest on bonds, notes, or other interest-bearing obligations of domestic corporations or certain non-corporate residents. Section 862(a)(1) provides that interest income shall be treated as income from sources without the United States if it is interest other than that derived from sources within the United States as provided in § 861(a)(1). The Tax Exempt Entity in this O-FSC is not, to our knowlege, a domestic corporation.

States; and (3) this interest would be paid by a foreign corporation with gross income none of which was effectively connected with the conduct of a trade or business within the United States under Treas. Reg. § 1.861-2(b)(3)(i)(b).

In computing the limitation for a FTC claimed under § 906(a), taxable income is to include only the income that is ECI; see § 906(b)(2). Moreover, per § 904(d)(1)(C), the FTC limitation shall be applied separately with respect to specified categories of income, including financial services income. Section 904(d)(2) contains definitions and special rules for calculating the FTC limitation. Section 904(d)(2)(C)(i) defines "financial services income" as any income received by any person predominantly engaged in the active conduct of a bank, financing, or similar business and which is described in clause (ii). In turn, § 904(d)(2)(C)(ii) provides a general description of financial services income as including income derived in the active conduct of a banking, financing, or similar business.

Section 904(d)(3)(D) provides that any dividend paid out of the earnings and profits of any controlled foreign corporation (CFC) in which the taxpayer is a United States shareholder shall be treated as income in a "separate category" in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the CFC.[5] Financial services income is income in a "separate category". Section 904(d)(3)(F)(i). Therefore, the income of the parent/taxpayer is considered financial services income. The dividend that is taken into account is, however, the gross dividend reduced by any dividend received deduction allowed to the shareholder under § 245.

Internal Revenue Code § 245(c)(1)(A) provides that in the case of a domestic corporation, there shall be allowed as a deduction an amount equal to 100 percent of any dividend received from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC. However, § 245(c)(1)(B) limits the deduction to an amount equal to 80 percent in the case of dividends from a 20-percent owned FSC which is distributed out of earnings and profits attributed to ECI of the FSC. For purposes of § 245(c), the term "ECI" means ECI that does not also qualify as FTI. Section 245(c)(3). Since we concluded in Issue 1 that the recharacterized interest income paid to TP-FSC by the foreign Tax Exempt Entity here is ECI but

---

[5] See Internal Revenue Code §§ 951(b) and 957 for the definitions of U.S. shareholder and CFC, respectively.

not also FTI, the parent/taxpayer is entitled only to a DRD of 80 percent with respect to its interest income (rather than the claimed 100 percent with respect to its FTI/rental income.)

Because the 20 percent of the dividend is attributed to TP-FSC's foreign source interest income, that 20 percent will increase the parent/taxpayer's financial services basket FTC limitation as determined under § 904(d). In contrast, as suggested in the previous paragraph, if the income were characterized as rental income, a 100 percent DRD would apply. We note that recharacterizing this O-FSC as a financing arrangement would make the interest income of TP-FSC possibly subject to double taxation because the interest income will be taxed by the United States at the TP-FSC level and again, to the extent of 20 percent, at the parent/taxpayer level. The tax at the parent/taxpayer level could be eliminated to the extent that the additional foreign source income equal to 20 percent of the dividend increases the parent/taxpayer's

§ 904(d) limitation and if the parent/taxpayer was in an excess credit situation.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please contact Diane Mirabito at (516) 688-1709 if you have any questions.

JODY TANCER
Associate Area Counsel
(Large and Mid-Size Business)

By:_____
DIANE R. MIRABITO
Attorney (LMSB)