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INDUSTRY SPECIALIZATION PROGRAM
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INDUSTRY: Commercial Banking
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Withholding Foreign Tax Credits and Gross-Up
Income Accruals
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SETTLEMENT POSITION

CROSS-BORDER LOANS (PRIMARILY NET LOANS) WITHHOLDING FOREIGN
TAX CREDITS AND GROSS-UP INCOME ACCRUALS
PURPOSE

The purpose of this document is to provide guidance to Appeals officers in the settlement of withholding foreign tax credit and gross-up income accrual issues that have arisen in recent years with respect to cross-border loans (primarily net loans) in the commercial banking Industry specialization program.

This document is not intended to be a directive. Thus, Appeals officers should not view these guidelines as being restrictive, but instead should use them for technical assistance in evaluating these issues.

INDUSTRY SPECIALIZATION PROGRAM

These settlement guidelines are issued by the Appeals 15P coordinator for commercial banking, North Atlantic Region.

All proposed settlements of the issues discussed herein must be approved by the Appeals ISP Coordinator. In reviewing the proposed settlements, the Coordinator will take into account recent developments discussed in these guidelines.

DISCLOSURE

This document should not be disclosed to anyone outside the IRS, including any taxpayer involved with an issue discussed herein. This document is for use within the IRS and should be limited to those who have withholding foreign tax credit and gross-up income accrual issues:

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SETTLEMENT GUIDELINES

CROSS-BORDER LOANS (PRIMARILY NET LOANS) WITHHOLDING FOREIGN TAX CREDITS AND GROSS-UP INCOME ACCRUALS

1. STATEMENT OF ISSUES

A. Brazilian Foreign Tax Credits and Gross-Up Income Accruals

- i. Whether the U.S. lender is legally liable for the Brazilian withholding tax and entitled to claim a foreign tax credit and related gross-up.
- ii. Whether, in the alternative to (i), the amount of creditable tax (and gross-up) should be reduced by withholding tax subsidies paid by the Brazilian government to Brazilian borrowers.
- iii. Whether, in the alternative to (i), the amount of creditable tax (and gross-up) should be reduced by the amount of withholding tax assumed by the Central Bank with respect to customary Central Bank deposits.
- iv. Whether, in the alternative to (i), the amount of creditable tax (and gross-up) should be reduced by the amount of withholding tax assumed by the Central Bank with respect to restructured Brazilian debt.

B. Net Loan Foreign Tax Credits and Gross-Up Income Accruals in General

- i. Whether the amounts of claimed withholding foreign tax credits are proven and documented by tax receipts or acceptable secondary evidence.
- ii. Whether the U.S. lender must accrue the gross-up of the withholding tax on net loans notwithstanding the disallowance of the foreign tax credit for failure of proof.

2. EXAMINATION DIVISION'S POSITION

A. Brazilian Foreign Tax credits' and Gross-Up Income Accruals

- i. The U.S. lender is not legally liable for the Brazilian withholding tax, and not entitled to claim a foreign tax credit and related gross-up.
- ii. In the alternative to (i), the amount of creditable tax (and gross-up) should be reduced by withholding tax subsidies paid by the Brazilian government to Brazilian borrowers.
- iii. In the alternative to (i), the amount of creditable tax (and gross-up) should be reduced by the amount of withholding tax assumed by the Central Bank with respect to customary Central Bank deposits.

- iv. In the alternative to (i), the amount of creditable tax (and gross-up) should be reduced by the amount of withholding tax assumed by the Central Bank with respect to restructured Brazilian debt.

B. Net Loan Foreign Tax Credits and Gross-Up Income Accruals in General

- i. The amounts of claimed withholding foreign tax credits must be proven and documented by tax receipts or acceptable secondary evidence.
- ii. The U.S. lender must accrue the gross-up of the withholding tax on net loans notwithstanding the disallowance of the foreign tax credit for failure of proof.

3. BACKGROUND

"Gross and Net" Loans U.S. banks make cross-border "gross loans" and "net loans" to foreign borrowers, which are typically long-term. A "gross loan" is a loan in which the borrower agrees to pay interest (typically quoted as a spread above LIBOR or prime rate every six months) from which any foreign withholding tax will be deducted before remitting a cash interest payment. The economic burden of the withholding tax, and the risk of withholding tax rate fluctuations over the term of the loan, falls on the lender.

A "net loan" is a loan in which the borrower agrees to pay interest (typically quoted as a spread above LIBOR or prime rate every six months) without any deduction for the foreign withholding tax; thereby remitting a cash interest payment equal to the quoted interest rate: U.S. banks prefer "net loans" because the economic burden of the tax and the risk of tax rate fluctuations are shifted to the foreign borrower. Moreover, if all foreign tax credit and income accrual conditions are met, the U.S. bank enjoys the combined benefit of the foreign tax credit and income accrual (the benefit of the related foreign tax credit far outweighs the detrimental inclusion of the gross-up income at U.S. corporate rates).

Creditability. The principal conditions for creditability of a foreign tax that are the subject of the issues discussed herein are:

- (1) legal liability on the part of the U.S. lender for the withholding tax (including the question of whether loans to certain foreign borrowers are legally or de facto exempt from the tax);
- (2) actual payment of the full amount of the withholding tax to the foreign tax authorities (including questions of refunds, rebates and subsidies that diminish the tax paid]; and
- (3) positive proof of tax payment through tax receipts or other acceptable secondary evidence.

As discussed in detail below, the examination division will typically disallow both claimed foreign tax credits and the related gross-up income accruals when conditions (1) or (2) are not met, because these conditions apply equally to both creditability and accrual. However, when only condition (3) is not met, the income accrual may be proper but the foreign tax credit is disallowed.

A. BRAZILIAN FOREIGN TAX CREDITS AND GROSS-UP INCOME ACCRUALS

Most cross-border loans to Brazil are net loans. The Court in *Nissho Iwai American Corporation v. Commissioner*, 89 T.C. 765 (1987) stated with respect to Brazilian net loans, "The difference between a gross loan and a net loan is that in the former the quoted interest rate is a gross rate which does not guarantee the lender a fixed rate of return after deduction of the withholding tax, whereas in the latter, the interest rate quoted is net of withholding tax." By its very terms, a net loan means that "all payments of principal and interest were to be free and clear of, and without deduction for any taxes imposed by Brazil."

Withholding Tax Brazilian law requires that a stated 25% withholding tax be paid on interest paid to foreign lenders. (For the years 1975 to 1985, the effective rate of tax was reduced by the "pecuniary benefit.") In a net loan, the amount of withholding tax is calculated by reference to a "gross-up" calculation, resulting in a stated withholding tax equal to .333 of the net interest payment.

"DARF" For all loans, the tax is paid by the Brazilian borrower at a Brazilian commercial bank, and is accompanied by a document (tax receipt) filled out by the borrower known as a "DARF" (Documento de Arrecadação de Receitas Federais). The Brazilian borrower may be a commercial bank authorized to collect taxes on behalf of the government, in which case the DARF reflects the name of the bank as both borrower and collecting bank.

The DARF is a four copy form. Two copies are stamped by the commercial bank to evidence payment of the withholding tax and are returned to the borrower. These two copies are then submitted with a request for payment of foreign currency to the central Bank to show that the required tax was paid. When the tax is imposed (i.e. when the loan or borrower is not tax exempt), the Central Bank will not approve a request to pay interest to a foreign lender unless the request is accompanied by a DARE

When the Central Bank approves the payment of interest to a foreign lender, it returns to the borrower a stamped copy of the DARE with the exchange contract. The exchange contract also evidences payment of the tax. Typically the borrower forwards a copy of the DARF to the foreign lender accompanied by a letter identifying the DARE in terms of a contemporaneous interest payment.

Categories of Loans. The Central Bank approves all foreign loans, which enter the country in foreign currency (e.g., dollars) and are converted to local currency (e.g., cruzeiros) for use by the Brazilian borrower. The loans fall into three basic categories:

- (a) "4131 loans" are direct loans between a foreign lender and a Brazilian borrower or government agency (not a Brazilian bank) .
- (b) "Resolution 229 loans" are a variation of "4131 loans."
- (c) "Resolution 63 loans" are loans from a foreign bank to a Brazilian bank for the purpose of repass to the Brazilian bank's clients on a smaller scale (in lesser amounts and for shorter maturities). The repass borrowers are required to pay their pro-rata share of the principal, interest and withholding tax, plus repass commission."

LIBOR Rate. The Central Bank of Brazil generally limited the interest rate charged by a lending bank to "LIBOR" (London Interbank Offering Rate) plus a 2.5% spread. "LIBOR" is the cost of funds to a lending bank. Generally, the spread between "LIBOR" and the interest rate charged was between one percent and 2.5%.

The components of the cost of funds to a Brazilian borrower on a foreign net loan were:

- (a) LIBOR plus the spread charged by the foreign lender,
- (b) plus currency fluctuations, and
- (c) the withholding tax.

While there are strict exchange controls with respect to Brazilian loans which mandate the payment of the withholding tax prior to the remittance of interest payments to foreign lenders, it is important to note that not all interest payments to U.S. banks are subject to the tax. There are a variety of laws in Brazil that provide for exemptions from the tax, particularly in net loans. Proof of exemptions are available from the Brazilian borrowers, and typically the borrowers advise the U.S. banks of such exemptions in order to explain the absence of DARFs with respect to interest payments.

Some U.S. banks claim Brazilian foreign tax credits (and related income accruals) based on a relatively careful distinction between taxable and tax exempt interest payments. These banks analyze the DARFs and other documents (correspondence) provided by the Brazilian borrowers, and claim credits only when the tax is imposed and the DARFs are provided. (No U.S. banks follow the Commissioner's primary position on legal liability, discussed below).

On the other hand, many U.S. banks disregard the details of their Brazilian loans. In order to maximize their foreign tax credits, they simply total all of their interest payments from Brazil and apply the 33% gross-up calculation, without regard to tax exemptions and the documentation of tax payments.

B. NET LOAN FOREIGN TAX CREDITS AND GROSS-UP INCOME ACCRUALS IN GENERAL

The amount of withholding tax imposed on cross-border interest payments varies from country to country. This amount not only varies with respect to the rate of tax, but also varies with respect to the method of calculating the tax. In net loans, most foreign countries treat the assumption of the tax liability of the lender as additional income to the borrower (as in Brazil), and the amount of the withholding tax is computed through a "gross-up." In a few countries, there is no gross-up calculation in a net loan. Rather, the net interest payment is simply multiplied by the stated tax rate to arrive at the amount of tax owed.

There are a variety of exemptions available on a country-by-country basis. Further, not all countries impose a withholding tax on interest payments.

Tax Receipts. When a foreign withholding tax is paid, foreign borrowers typically forward the foreign tax receipts to U.S. banks accompanied by letters explaining the receipts. For most countries, the foreign borrowers are required to forward the tax receipts by law and/or by contract (the loan agreement).

As in the case of Brazilian loans, some U.S. banks claim foreign tax credits (and related income accruals) based on a relatively careful distinction between taxable and tax exempt interest payments. These banks analyze the tax receipts and other documents (correspondence) provided by the foreign borrowers, and claim credits only when the tax is imposed and tax receipts are provided. On the other hand, many U.S. banks disregard the details of their cross-border loans. In order to maximize their foreign tax credits, they simply total all of their interest payments from the foreign countries and apply the tax rate (generally with a gross-up calculation), without regard to tax exemptions and the documentation of tax payments.

4. DISCUSSION OF ARGUMENTS

A. BRAZILIAN FOREIGN TAX CREDITS AND GROSS-UP INCOME ACCRUALS

i. WHETHER THE U.S. LENDER IS LEGALLY LIABLE FOR THE BRAZILIAN WITHHOLDING TAX AND ENTITLED TO CLAIM A FOREIGN TAX CREDIT AND RELATED GROSS-UP.

Legal Liability. In order to claim a foreign tax credit under IRC section 901, the U.S. taxpayer must be legally liable for the tax "paid or accrued" to the foreign government. *Biddle v. Commissioner*, 302 U.S. 573 (1938); Temp. Treas. Reg. section 4.901-2(g)(1) (for tax years ending after June 15, 1979); Treas. Reg. section 1.90-2(f)(1) (for tax years ending after November 14, 1983).

As a primary position with respect to the Brazilian withholding tax on interest payments, the Commissioner disallows the full amount of the claimed credits (and related income accruals) for both net and gross loans based on an interpretation of Brazilian law that the U.S. lender is not legally liable for the tax. Under Brazil's "exclusive" withholding tax system applicable to income such as wages), legal liability for the Brazilian withholding tax on income remitted abroad is not imposed on the U.S. recipient of the income.

Rather, legal liability is imposed only on the source of the income. Accordingly, no amount of the Brazilian withholding tax is creditable. Rev. Rul. 70-49, 1970-1 C.B. 158, as modified by Rev. Rul. 78-258, 1978-1 C.B. 239, held that the Brazilian withholding tax on income remitted abroad was an income tax allowable as a credit under IRC section 901. For tax years ending after June 15, 1979, Rev. Rul. 70-49 has been declared obsolete. Rev. Rul. 89-118, 1989-2 C.B. 275; Rev. Rul. 89-119, 1989-2 C.B. 132, as modified by Ann. 89-152, 1989-48 I.R.B. 21.

Banking Industry Position. The banking industry disagrees with the Commissioner's position on the legal liability issue. The industry argues that the Brazilian withholding tax is an income tax imposed on the U.S. recipient of the income within the concept of the U.S. tax system. The Brazilian borrower is legally obligated to withhold and pay over the tax from interest income paid to the foreign lender, who is considered the "taxpayer." Under the "exclusive" withholding tax system, the onus of the tax remains on the foreign lender. Accordingly, the full amount of the withholding tax is available for a foreign tax credit (and related income accrual).

IRS position. To date, the Commissioner has not prevailed on the legal liability issue in the Tax Court. However, the Commissioner has not acquiesced on this issue and continues to pursue a reversal of the Tax Court through appellate review. The commissioner believes that the Tax court rendered an opinion on the legal liability issue that is contrary to the principles governing the legal liability requirement for claiming foreign tax credits (interpreting Brazilian law) as set forth by the supreme Court in the Biddle case (and other case law), and section 901 and the regulations thereunder.

Court Decisions. In *Nissho Iwai American Corporation v. Commissioner*, 89 T.C. 765 (1987), the Tax Court relied on the U.S. wage withholding system and agreed with the taxpayer that the tax was "imposed on the [U.S.] lender, "while the Brazilian borrower was "simply the person required to pay the tax on behalf of the foreign lender." The Commissioner did not appeal the *Nissho Iwai* case to the 2d circuit because of an incomplete record.

Notwithstanding a more complete record regarding the exclusive withholding tax system in Brazil, the Tax Court in *Continental Illinois Corporation v. Commissioner and Citizens and Southern Corporation & Subsidiaries v. Commissioner*, T.C. Memo. 1988- 38, followed its opinion in *Nissho Iwai* and ruled for the taxpayer on the legal liability issue. The Commissioner was unsuccessful on appeal of the legal liability issue with respect to the taxpayers *Citizens and Southern and Continental Illinois. Citizens and Southern Corporation and Subsidiaries v. Commissioner*, 919 F.2d 1492 (11th Cir. 1990) (per curiam affirmance without an opinion) and *Continental Illinois Corporation v. Commissioner*, 72 A.F.T.R. 2d (P-H) 5308 (7th Cir. July 9, 1993). See also, *First Chicago Corporation v. Commissioner*, T.C. Memo. 1991-44 (7th Circuit appellate venue, but decision not final); *Northern Corporation and Affiliated Companies v. Commissioner*, T.C. Memo. 1992-282 (Appeal Docketed in 8th Circuit).

ii. WHETHER, IN THE ALTERNATIVE TO (i), THE AMOUNT OF CREDIBLE TAX (AND GROSS-UP) SHOULD BE REDUCED BY WITHHOLDING TAX SUBSIDIES PAID BY THE BRAZILIAN GOVERNMENT TO BRAZILIAN BORROWERS.

Subsidy for Brazilian Borrowers. Foreign tax credits claimed under IRC section 901 are limited to the amount of tax actually paid to a foreign government, and do not include amounts not retained by the foreign government due to refunds, rebates, credits or subsidiaries Temp. Treas. Reg. section 4.901-2(F)(2) and (3) generally for tax years ending after June 15, 1979); Treas. Reg. section 1.901-2(e)(2) and (3) (generally for tax years ending after November 14, 1983); Treas. Reg. section 1.901-2(e)(3) (revised section on subsidies for tax years beginning after December 31, 1986); IRC section 901(i) (for tax years beginning after December 31, 1986).

Subsidy Amounts. The "pecuniary benefit" legislation effective in Brazil between 1975 and 1985 gave rise to the disallowance by the Commissioner of a portion of the Brazilian withholding tax as a creditable tax (and as a related income accrual). In October of 1974, the stated withholding imposed on interest payments was reduced from 25% to 5% in order to reduce borrowing costs to Brazilian borrowers and encourage an inflow of foreign currency to boost the Central Bank's reserves. As a result of complaints from foreign banks (primarily U.S. banks) that the reduction also reduced their foreign tax credit claims, on August 5, 1975, the 25% rate was reinstated.

Also, on August 5, 1975, the Central Bank issued Resolution 335 which provided that Brazilian borrowers of foreign loans would receive a "pecuniary benefit" equivalent to 85 percent of the Income tax paid as a result of the application of the rate of 25 percent on the interest on such loans. The original amount of the pecuniary benefit and subsequent changes are as follows:

Date	Pecuniary Benefit -- % of Tax
August 5, 1975	85%
July 26, 1979	50%
December 7, 1979	95%
May 8, 1980	40%
July 28, 1985	- 0 -

The "payment" of the tax and the "payment" of the pecuniary benefit were made simultaneously at the collecting commercial banks in Brazil by means of debits and credits, and the net amount (the 25% tax less the pecuniary benefit) was paid to the Brazilian treasury. In the case of Resolution 63 loans (repass loans), the pecuniary benefit reduced the amount of the pro-rata portion of the withholding tax cost assumed by the repass borrower. There was no requirement that the pecuniary benefit be shown on the DARF.

Alternative Position. As an alternative position with respect to the Brazilian withholding tax on interest payments, the Commissioner disallows the amount of the claimed credits (and related income accruals) for both net and gross loans to the extent the claimed credits (and related income accruals) equal the pecuniary benefit. Rev. Rul. 78-258, 1978-1 C.B. -239 (two-party loan; grandfather clause for interest accrued or received prior to January 1, 1980, for loans entered into prior to March 16, 1978); TAM 8718010 (January 16, 1987) (three-party Resolution 63 loans]. See also, the temporary and final regulations discussed above.

Most U.S. banks continue to disagree with the Commissioner's position on the pecuniary benefit, or subsidy, issue. Generally, they argue that the pecuniary benefit legislation should not have the effect of reducing the U.S. lender's foreign tax credit and income accruals on the basis that the subsidy regulations are invalid and should not apply to situations where the lender does not derive an economic benefit from the subsidy, or that the withholding tax paid should not lose its status because the Brazilian taxing authority allocates a portion of the tax to a specific program.

The taxpayers generally rely upon *Missouri Pacific R. R. Co. v. United States*, 497 F.2d 1386 (Ct. Cl. 1974) and other similar cases, in which it was determined that a Mexican withholding tax imposed on freight car rentals was creditable even though Mexico granted to the Mexican railroad car company a subsidy equal to the amount of tax withheld. Further, U.S. banks argue that even if the regulations are valid, they do not apply to the three-party Resolution 63 loans because the recipient of the subsidy is not related to or engaged in a business transaction with the U.S. taxpayer.

IRS Prevails on Subsidy Issue. To date, the Commissioner has prevailed on the subsidy issue in the Tax Court, in both two- party and three-party loans. In *Nissho Iwai American Corporation v. Commissioner*, 89 T.C. 765 (1987), the taxpayer argued that it was entitled to a credit for the amount of tax withheld unreduced by the pecuniary benefit paid to the borrower. The government's position was that a subsidy which was determined directly or indirectly by reference to the amount of income tax is not creditable. Temp. Treas. Reg. section 4.901-2(f)(3).

The Court recognized that technical legal liability for a withholding tax is not the end of the inquiry in terms of creditability, and disallowed the pecuniary benefit portion of the Brazilian withholding tax because the facts (including Brazilian law) established that is portion of the tax was not paid to the Brazilian government within the meaning of the temporary regulations. The Tax Court believed that the temporary regulations had the same weight as final regulations, and that they must be sustained unless unreasonable and plainly inconsistent with the revenue statutes.

The cases used to support the taxpayer's argument predated the temporary regulations. With respect to these "Mexican railroad cases" the Tax Court stated, "We believe the years have sapped such decisions of whatever vitality they may have had. Accordingly, we decline to follow the holdings of those cases."

Further, the Tax Court in *Nissho Iwai* found that, "Payment of the tax and receipt of the subsidy are in lockstep. Common sense dictates that the payment of the tax and receipt of the subsidy be viewed together in determining the amount of foreign taxes creditable for purposes of section 901. If we accept payment of the Brazilian taxes as one transaction and receipt of the subsidy as another, we would ignore the true unity of the transaction and elevate form over substance; this we shall not do." The taxpayer in this case did not appeal the loss of the subsidy issue in the two- party loan at issue to the 2d Circuit.

Continental Illinois Corporation v. Commissioner and citizens and Southern Corporation & Subsidiaries v. Commissioner, T.C. Memo. 1988-318 involved both two-party and three-party net loans: Therein, more evidence of the true motive behind-the institution of the pecuniary benefit was presented by the Commissioner, and the Court stated:

We believe that the 1975 pecuniary benefit legislation was devised to maintain for Brazilian net loan borrowers the economic benefits of the 1974 withholding tax reduction from 25 to 5 percent while restoring to foreign lenders the foreign tax credit benefits of a withholding tax rate of 25 percent. In the context of net loans, the 1975 pecuniary benefit legislation had the same economic effect as the 1974 tax reduction on both Brazilian borrowers and the Brazilian Treasury. Nor did the 1975 pecuniary benefit legislation change the pre-tax (U.S.) economic status of petitioners and other U.S. lenders with net loans. However, by providing inflated foreign tax credits for petitioners and other U.S. lenders, the 1975 pecuniary benefit legislation allowed petitioners and other U.S. lenders to benefit taxwise at the expense of the U.S. Treasury.

Appeals of Court Cases. The taxpayer Citizens and Southern did not appeal the loss on this issue to the 11th Circuit. The taxpayer Continental Illinois appealed the subsidy issue to the 7th Circuit which affirmed the Tax Court with respect to the subsidy issue under Temp. Treas. Reg. section 4.901-2(f)(3). The taxpayer appealed the issue to the 8th Circuit in *Norwest Corporation and Affiliated Companies v. Commissioner*, T.C. Memo. 1992-282. See also, *First Chicago Corporation v. Commissioner*, T.C. Memo. 1991-44 (7th Circuit appellate venue, but decision not final).

iii. WHETHER, IN THE ALTERNATIVE TO (i), THE AMOUNT OF CREDITABLE TAX (AND GROSS-UP) SHOULD BE REDUCED BY THE AMOUNT OF WITHHOLDING TAX ASSUMED BY THE CENTRAL BANK WITH RESPECT TO CUSTOMARY CENTRAL BANK DEPOSITS.

Central Bank Issue. During the 1970's and 1980's (and into the 1990's), portions of foreign net loans to Brazil (both two-party and three-party loans) were customarily deposited at the Central Bank. The Central Bank assumed the responsibility for the interest payments on such customary deposits, and the economic burden of the withholding tax thereon. However, the Central Bank enjoyed a long-standing immunity (either legal or de facto), from the payment of the tax. No withholding tax was paid, and no DARFs were issued, on customary deposits in net loans. As a result of the practice of Brazilian borrowers to send correspondence to U.S. banks accompanying and explaining the DARFs issued on the portions of the loans that were not deposited with the Central Bank, U.S. banks with Brazilian loans have long been aware of the Central Bank's immunity from the withholding tax and the fact that no DARFs were prepared with respect to the customary Central Bank deposits.

The issue has particular significance during the early and mid- 1980's, because at these times often large portions of loans to Brazil were on deposit at the Central Bank.

As discussed above, some U.S. banks have not claimed foreign tax credits (and related income accruals) for the portion of their loans placed on deposit at the Central Bank. However, many U.S. banks have ignored the recognized immunity of the Central Bank and claimed the credits notwithstanding the absence of DARFs and the other documentation provided by Brazilian borrowers. These banks argue that the withholding tax was legally "imposed" on the foreign lender, and that the tax was somehow "withheld" by the Central Bank. They argue that the recognized immunity of the Central Bank, the lack of payment of the tax by the Central Bank, and the lack of proof of such payment are all irrelevant to creditability.

The Commissioner prevailed on the Central Bank customary deposit in *Nissho Iwai American Corporation v. Commissioner*, 89 T.C. 765 (1987), which involved Central Bank deposits under Resolution 432 (instituted on June 23, 1977). The taxpayer had not originally claimed as a credit the proportionate amount of the withholding tax assumed by the Central Bank, but claimed entitlement to a credit in the course of litigation. The taxpayer had no DARS to support its credit claims, and the Tax Court disallowed the claimed credit (and income accrual) for failure of proof. See also, *Continental Illinois Corporation*, supra, in which petitioners conceded the Central Bank deposit interest payments.

* * *

B. NET LOAN FOREIGN TAX CREDITS AND GROSS-UP INCOME ACCRUALS IN GENERAL

i. WHETHER THE AMOUNTS OF CLAWED WITHHOLDING FOREIGN TAX CREDITS

ARE PROVEN AND DOCUMENTED BY TAX RECEIPTS OR ACCEPTABLE

SECONDARY EVIDENCE.

The "Lederman" Issue Since the mid-1970s, U.S. commercial banks have sought to reduce their U.S. tax liabilities through a variety of improper foreign tax credit claims linked to the burgeoning foreign debt represented by cross-border net loans. In connection with the enactment of section 901(i) pertaining to subsidies, the Conference Committee Report Accompanying H.R. 3838, H.R. Rep. 99-841, 99th Cong., 201 Sess. 594 (1986) reflects the scope of potential abuse regarding proof of foreign tax credits when it states:

The conferees intend that the amount of any withholding tax paid be positively established through documentation provided in accordance with the requirements of Code section 905(b) and Treas. reg. sec. 1.905-2. In this regard, the conferees emphasize that the mere fact that withholding took place does not necessarily constitute adequate proof of the amount of tax paid.

The conferees believe that the rule set forth in *Lederman v. Commissioner*, 6 T.C. 991 (1946), which suggests that payment is proved ipso facto by the act of withholding, is subject to abuse. Application of the Lederman rule is of particular concern in the context of a "net loan," under which the net amount paid to the U.S. payee is unaffected by the amount of tax withheld in such a case, it is impossible to determine prima facie whether a claimed amount withheld has actually been withheld, since the amount received by the payee remains unchanged. The logic of the Lederman rule simply does not apply in such circumstances, and external proof of withholding and payment over should be required.

The conferees' concern with respect to documentation of foreign taxes are heightened by the problem of subsidized foreign tax payments. The conferees are informed that in some cases amounts withheld are retained by the withholding agent, in whole or in part, with the explicit or implicit approval of the foreign sovereign. Particularly in the case of a net loan, both payee and payor stand to benefit from a high withholding "tax" that is never paid over to the government; the payor receives cash in hand (equivalent to a lower interest rate) while the payee receives a foreign tax credit for a fictional tax, without any reduction in net proceeds. Although this provision of the agreement, which codifies the prohibition of direct and indirect subsidies of foreign taxes, confirms that a foreign tax credit is disallowed in such cases, the conferees are concerned that without a strict documentation requirement the Service would find it difficult to determine when such a subsidy had been given. Therefore the conferees expect that a receipt or other positive proof of payment will generally be required establish the amount of foreign withholding tax paid with respect to

foreign source interest income received by U.S. taxpayers.
(emphasis added).

In *Lederman*, two Philippine companies that deducted and withheld eight percent of dividend payments to a U.S. taxpayer (dividend declared gross of the tax) did not pay over the withheld tax to the Philippine government because of the Japanese invasion. As of the time of the trial, the sources had not paid over the tax but intended to do so once the duly constituted government was established.

The Tax Court held that the taxpayer was entitled to a foreign tax credit as a tax "paid" (without having to furnish a bond) for the amount of the tax withheld, but not yet paid over, because he furnished direct evidence of withholding at the source. Relying on *Pacific Metals v. Commissioner*, 1 T.C. 1028 (1943), the Court in *Lederman* allowed the tax credit on a provisional or interim basis, without prejudice to the respondent to disallow the credit under the predecessor to section 905(c) if the tax was not actually paid over to the Philippine government. The IRS acquiesced.

The case of *Continental Illinois Corporation v. Commissioner*, T.C. Memo 1991-66, served as the test case of the so-called "Lederman issue" as it applies to withholding taxes on interest payments in cross-border net-loans. Under an erroneous reading of the *Lederman* case, many U.S. banks have been claiming foreign tax credits without any proof of tax payment, but based solely by reference to a fictional "withholding" and a calculation of the amount of withholding tax due on a cross-border net loan interest payment (i.e., the calculation of the gross-up). /2/ According to these banks, proof of payment of the tax through tax receipts (direct evidence) or by proper secondary evidence is not required by the code and regulations for net loan withholding taxes.

Proof of Payment. According to the Commissioner, foreign tax credits for withholding taxes must be proven by evidence of tax payment, as required by sections 901 and 905(b) and (c). Direct and secondary evidence of withholding as defined in Treas. Reg. section 1.905-2(b)(3) is sufficient to initially claim a foreign tax credit on a return, but the taxpayer remains under the duty to prove the tax payment in the manner prescribed by Treas. Reg. sections 1.905-2(a)(2) (direct evidence) and (b)(1) (secondary evidence). *Lederman* and *Pacific Metals*.

In *Continental Illinois*, the Tax Court agreed with the Commissioner and rejected the taxpayer's displaced reliance on *Lederman* underlying a claim of \$ 2.9 of foreign tax credits pursuant to the principles of *Pacific Metals*, the Court found that "taxpayer[s] must ultimately provide direct or secondary evidence of actual payment of the foreign withholding tax to the foreign government in order to be entitled to the claimed foreign tax credit. . . ." The 7th Circuit (cite on page 7) upheld the Tax Court on this issue and the taxpayer did not file for certiorari.

The "Borrower Letter" Issue. The applicable regulations for proof of payment of foreign taxes are Treas. Reg. section 1.905-2(a)(2) (direct evidence) and (b)(1) (secondary evidence). Treas. Reg. section 1.905-2(a)(2) provides in pertinent part with respect to proof of a tax payment by a corporate taxpayer:

Except where it is established to the satisfaction of the district director that it is impossible to furnish such evidence, the form [1118] must have attached to it (i) the receipt for each such tax payment if credit is sought for taxes already paid. . . .

Treas. Reg. section 1.905-2(b) provides in pertinent part:
Secondary evidence. here it has been established to the satisfaction of the district director that it is impossible to furnish a receipt for such foreign tax payment . . . , the district director may, in his discretion, accept secondary evidence thereof as follows:

(1) Receipt for payment. In the absence of a receipt for payment of foreign taxes there shall be submitted a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income.

In addition to relying on Lederman, virtually all U.S. commercial banks submit to the Commissioner "borrower letters" when they are unable to obtain tax receipts. Most of these borrower letters do not meet the secondary evidence rules of Treas. Reg. section 1.905-2(b) (1) because:

- (1) the taxpayers have not established to the satisfaction of the district director that it is "impossible" to furnish a tax receipt; and
- (2) the borrower letters are mere statements by the borrowers that taxes are paid (or withheld or assumed), and are not accompanied by the required "photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income.

Secondary Evidence. The submission of borrower letters that do not meet the secondary evidence rules of Treas. Reg. section 1.905-2(b)(1) has become a widespread practice by U.S. commercial banks at the examination and appeals levels. Often, one-single letter will be offered to support millions of dollars of claimed credits spanning several years, without any explanation as to the absence of tax receipts or photostatic copies of checks, drafts, or other medium of payment. In essence, through the submission of unsubstantiated statements by third parties who are beyond the summons and subpoena power of the Commissioner U.S. commercial banks attempt to improperly boost their foreign tax credit claims as an alternative to the Lederman approach.

In the Tax Court case (T.C. Memo-1991-66), The Court disallowed credits for borrower letters that stated that taxes were withheld only, but allowed credits for borrower letters that stated taxes were paid -- notwithstanding the absence of underlying evidence of payment as required by the regulations. The Commissioner appealed this issue due to the administrative importance and the 7th Circuit reversed, thereby accepting the Commissioner's position that all borrower letters must be accompanied by evidence of payment.

It is important for purposes of illustrating the need for strict documentation of foreign tax payments as required by Treas. Reg. section 1.905-2(a)(2) and (b)(1) to note that Continental Illinois also relied on borrower letters from two Mexican borrowers, Pemex and CFE, to support a total of \$ 4,809,179 of claimed foreign tax credits. The Commissioner developed affirmative evidence that discredited these borrower letters and established that Pemex and CFE enjoyed a de facto exemption from the tax.

The Court disallowed the Pemex and CFE foreign tax credits, and the taxpayer has not appealed the separate Pemex and CFE exemption issue. Had respondent not taken the initiative to discredit the borrower letters offered by petitioner with respect to Pemex and CFE, the Tax Court would likely have concluded that respondent's rejection of these letters also constituted an abuse of discretion. However, as evidenced by the 7th Circuit reversal on the borrower letter issue, the 7th Circuit would not have allowed the credits for the Pemex and CFE letters either.

ii. WHETHER THE U.S. LENDER MUST ACCRUE THE GROSS-UP OF THE WITHHOLDING TAX ON MET LOANS NOTWITHSTANDING THE DISALLOWANCE OF THE FOREIGN TAX CREDIT FOR FAILURE OF PROOF.

Accrue Additional Income. The Commissioner's position is that if the U.S. lender (accrual basis taxpayer) has legal liability to pay the withholding tax under foreign law and that liability has been assumed by the foreign borrower in a net quoted loan, the U.S. lender must accrue additional income at the time the assumed foreign tax liability is accruable by it under Treas. Reg. section 1.461-1(a), and not when the liability is ultimately satisfied by a payment of the tax by the foreign borrower. Rev. Rul. 57-106, 1957-1 C.B. 242.

If the withholding tax is subsequently not paid or there is no proof of tax payment and the foreign tax credit is disallowed, the accrual of income is not reversed in the year of the accrual. Rather, the U. S. taxpayer must prove a bad debt deduction under section 166 of the Code. Commissioner v. Terre Haute Electric Co., 67 F.2d 697 (7th Cir. 1934); T.A.M. 8617003 (December 30, 1985). Two different standards apply to the allowance of the foreign tax credit and the accrual of the income. Symmetry of the two issues is not required by IRC section 905(c), which provides for a redetermination of the U.S. lender's tax liability when the amount of tax paid to a foreign country does not equal the tax credit claimed.

The industry position is that there should be symmetry in the reporting of the foreign tax credit and the accrual of the additional income. Under *Terre Haute*, the U.S. lender must include in income the amount of the foreign tax when it becomes due and payable behalf by a foreign borrower. However, if it is later determined that the tax was not paid, the U.S. lender is entitled to reverse the accrual. *Acme Coal Company v. United States*, 44 F.2d 95 (Ct Cl. 1930); section 905(c).

The Commissioner won the gross-up issue in *Continental Illinois Corporation v. Commissioner*, T.C. Memo 1991-66. Although the foreign tax credits were disallowed, the taxpayer was required to include in income the amount of the foreign withholding tax assumed by the foreign borrowers in the cross-border net loans. The taxpayer appealed this decision to the seventh Circuit.

In *Continental Illinois Corporation v. Commissioner*, 93-2 U.S. Tax Cas. (CCH) par.50,400, 72 A.F.T.-R.2d (P-H) 5308 (7th Cir. July 9, 1993), the Seventh Circuit reversed the Tax Court, relying on the doctrine of judicial estoppel and ignoring basic income accrual principles. Judicial estoppel forbids a litigant from taking inconsistent legal positions. The Seventh Circuit stated that since the Commissioner "persuaded us to reject Continental's effort to show that the taxes were paid, the IRS may not argue against a restatement of income. on the ground that they really were paid." (original emphasis).

The Seventh Circuit incorrectly characterized the Commissioner'S argument on appeal. The Commissioner clearly argued that Continental was not entitled to foreign tax credits because it failed to prove the taxes were paid, not because the foreign taxes were not pad. As such, the Commissioner did not take inconsistent positions and the income accruals were proper notwithstanding Continental's failure to provide entitlement to its claimed foreign tax credits. However, because the Seventh Circuit's opinion focuses on judicial estoppel and not the law of income accruals, the significance of the case to income accrual area in general is de minimus. Further, we are not aware of a conflict among the circuits on this point, and therefore, we recommended against the filing of a petition for writ of certiorari.

5. SETTLEMENT GUIDELINES

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