



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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
(LM:HMT) - PHILADELPHIA

FROM: Assistant to the Branch Chief, CC:INTL:BR3

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated September 4, 2001. In accordance with I.R.C. §6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

USparent =
business a =
years b,c,
and d =
USsub1 =
USsub2 =
month e =
FrenchCFC =
amount f =
amount g =
FrenchHybrid =
amount h =

ISSUE

Whether the French withholding taxes imposed on the nontaxable year d distributions from FrenchCFC to USsub1 and from FrenchHybrid to USsub1 and USsub2 should be allocated to USparent's section 904(d) general limitation separate category.

CONCLUSION

On its consolidated federal income tax return for year d, USparent claimed a section 901 credit for the French withholding taxes in the general limitation separate category,

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apparently relying on the base difference rule in Treas. Reg. §1.904-6(a)(1)(iv). In general, the base difference rule is intended to have very narrow application. However, based on the facts of this case, in which the distributing entities had no income for U.S. tax purposes, allocation of the taxes to the general limitation separate category pursuant to the base difference rule is not unreasonable.

FACTS

USparent conducts business a. For the years at issue, USparent filed consolidated federal income tax returns. USsub1 and USsub2 were included in those returns.

In month e of year b, USparent acquired all of the stock of FrenchCFC, a publicly traded French holding company owning numerous subsidiaries, all of which were engaged in business a. Prior to month e of year b, USparent had owned no shares of FrenchCFC, and FrenchCFC had never been a controlled foreign corporation as defined in section 957(a) (“CFC”).¹ All of FrenchCFC’s income both before and after the acquisition was interest and dividends received from its subsidiaries.

On its consolidated federal income tax return for year b, USparent made an election pursuant to section 338(a) and (g) for its acquisition of FrenchCFC.² The purchase price of FrenchCFC (approximately amount f) exceeded the fair market value of its tangible assets by approximately amount g. Amount g was allocated to intangible assets subject to amortization under section 197.

USsub1 and USsub2 own 90% and 10%, respectively, of the ownership interests in FrenchHybrid, which was formed in year b. For French tax purposes, FrenchHybrid is taxable as a corporation and is the parent of a consolidated group of corporations. FrenchHybrid is recognized as a partnership for U.S. tax purposes. Ninety-five percent of the FrenchCFC stock was transferred to FrenchHybrid in a series of transactions during year b. The remaining 5% of FrenchCFC stock was transferred to USsub1.

¹Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

²Section 338(a) provides that a purchasing corporation, such as USparent, that makes a “qualified stock purchase” of at least 80% of the stock of a foreign target corporation, such as FrenchCFC, may make a section 338(a) and (g) election that results in a deemed sale of the target corporation’s assets. If the purchasing corporation makes this election, the “old” target is considered to sell all of its assets to a “new” target corporation as of the close of the acquisition date and is required to recognize gain or loss on its assets. See section 338(a). New target is treated as acquiring old target’s assets as of the beginning of the day after the acquisition date. Id. New target is entitled to an aggregate basis in the assets received from old target equal to the “adjusted grossed-up basis.” See Treas. Reg. §1.338(b)-1(a) (year b). This aggregate basis is then allocated among the assets of new target as provided by Treas. Reg. §1.338(b)-2T. Id. New target does not succeed to old target’s E&P accounts. See Treas. Reg. §1.338-2(d)(1) (year b). Here, FrenchCFC’s stock is not “carryover FT stock” since FrenchCFC had not been a CFC prior to acquisition in month e of year b. See Treas. Reg. §1.338-5(b)(3)(year b).

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In year d, FrenchCFC distributed amount h to USsub1 and FrenchHybrid. FrenchHybrid distributed the amount that it received, 95% of the distribution, to USsub1 and USsub2. Five percent of the distributions from FrenchCFC to USsub1 and from FrenchHybrid to USsub1 and USsub2 was withheld pursuant to Article 10(2)(a) of the income tax treaty between the United States and France (“Treaty”)³ since those distributions were determined by France to be dividends under Article 10 of the Treaty and under French tax law.⁴ On its consolidated federal income tax return for year d, USparent claimed a section 901 credit in the general limitation separate category for the withheld taxes.

FrenchCFC's profit and loss statements under French law reflected positive current earnings for years b, c, and d. However, due in large part to substantial required amortization deductions under section 197, USparent reported current and accumulated earnings and profits (“E&P”) deficits on the Forms 5471 filed for FrenchCFC for each of those years. FrenchCFC's profit under French law for each of the three years exceeded the distribution of amount h.

FrenchHybrid incurred expenses (principally interest expense) in years b, c, and d and had no income for U.S. tax purposes in those years. France treated the distributions to USsub1 and USsub2 as dividends based upon the distributable reserves of the FrenchHybrid consolidated group.

Due to FrenchCFC's lack of post-acquisition E&P under U.S. tax standards, and the section 338(a) and (g) election, which eliminated FrenchCFC's pre-acquisition E&P, USparent determined for purposes of its year d consolidated federal income tax return that the distributions made in that year by FrenchCFC to FrenchHybrid and USsub1 were returns of capital pursuant to section 301(c)(2) and therefore, not income to the recipients. Further, USparent determined that the year d distributions from FrenchHybrid to USsub1 and USsub2 were nontaxable partnership distributions under section 731(a).

³ Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31, 1994, U.S.-Fr.

⁴ Article 10(5)(a) of the Treaty defines dividends as “income from shares ... as well as income treated as a distribution by the taxation laws of the State of which the company making the distribution is a resident.” Article 10(2)(a) provides

Such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

(a) 5 percent of the gross amount of the dividends if the beneficial owner is a company that owns:

(i) ...

(ii) directly or indirectly, at least 10 percent of the capital of the company paying the dividend, if the company is a resident of France;

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LAW AND ANALYSIS

Section 901 allows U.S. taxpayers a credit for foreign income taxes paid or accrued. Under section 903, a foreign tax paid in lieu of an otherwise generally imposed foreign income tax is treated as a foreign income tax for purposes of section 901. The foreign tax credit is subject to the limitations of section 904(a) and (d). Section 904(a) limits the amount of foreign income taxes that may be credited in any one taxable year to the amount of a taxpayer's pre-credit U.S. income tax on its foreign source taxable income. The section 904(a) limitation is calculated separately for different categories of foreign source taxable income. Section 904(d).

Here, France treated the distributions from FrenchCFC to USsub1 and from FrenchHybrid to USsub1 and USsub2 as dividends and withheld 5% of the distributions pursuant to Article 10(2)(a) of the Treaty. For U.S. tax purposes, these distributions were treated as returns of capital under section 301(c)(2) and as nontaxable partnership distributions under section 731(a). On its consolidated federal income tax return for year d, USparent claimed a section 901 credit for those taxes even though none of the recipients of the distributions recognized income with respect to the distributions.

We have assumed, for purposes of this memorandum, that the French taxes withheld on the distributions are creditable taxes under section 901 or 903. Furthermore, the Code does not restrict the allowable credit to foreign taxes that are associated with specific items of foreign source income that are recognized both for U.S. and foreign purposes. See *Schering Corp. v. Commissioner*, 69 T.C. 579 (1978), *acq. in result*, AOD 1981-31 (credit allowed for Swiss withholding tax on payment treated as a dividend under Swiss law and as a nontaxable repayment of a receivable for U.S. purposes). Accordingly, the creditability of the French withholding taxes is not affected by the fact that the distributions are not income to the recipient for U.S. tax purposes. The issue here is in which separate category of income for purposes of section 904 should those withholding taxes be placed.

Treas. Reg. §1.904-6(a) provides rules to allocate foreign taxes paid or accrued to the section 904(d) separate categories of income. Under Treas. Reg. §1.904-6(a)(1)(i), foreign law applies to determine the income to which foreign taxes paid or accrued relate. Specifically, foreign taxes are related to income if the income is included in the base upon which the tax is imposed. *Id.* A foreign withholding tax, for example, is related to the income from which it is withheld. *Id.* Foreign taxes are allocated to a separate category by reference to the separate category to which the income taxed under foreign law would be assigned under U.S. tax principles. See Treas. Reg. §1.904-6(c), *Example (5)*.

In addition, the regulations provide that if a tax is related to more than one separate category, the tax is considered to be imposed on income in all such categories. Treas. Reg. §1.904-6(a)(1)(i). Accordingly, the tax is apportioned amongst the separate categories based on the amount of net income in each separate category subject to tax.

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Treas. Reg. §1.904-6(a)(1)(ii). For purposes of apportioning the tax, foreign law generally applies to determine the amounts of gross income in each separate category and the amount of deductions properly allocable thereto. *Id.*

Treas. Reg. §1.904-6(a)(1)(iv) provides special rules for allocating taxes in case of base and timing differences. That provision provides that

[i]f, under the law of a foreign country ..., a tax is imposed on an item of income that does not constitute income under United States tax principles, that tax shall be treated as imposed with respect to general limitation income. If, under the law of a foreign country ..., a tax is imposed on an item that would be income under United States tax principles in another year, that tax will be allocated to the appropriate separate category or categories as if the income were recognized under United States tax principles in the year in which the tax was imposed.

It is not entirely clear how the rules in Treas. Reg. §1.904-6 apply when a withholding tax is imposed on an item that is treated as a dividend for foreign tax purposes, but is a return of capital under U.S. tax principles.⁵ We have solicited comments on how the regulations could be amended to clarify the operation of Treas. Reg. §1.904-6(a)(1)(i) and (iv). See T.D. 8916, 2001-4 I.R.B. 360.

As stated above, on its consolidated federal income tax return for year d, USparent claimed a section 901 credit for the French withholding taxes in the general limitation separate category, apparently relying on the base difference rule in Treas. Reg. §1.904-6(a)(1)(iv). In general, the base difference rule is intended to have very narrow application. However, based on the facts of this case, in which the distributing entities had no income for U.S. tax purposes, allocation of the taxes to the general limitation separate category pursuant to the base difference rule is not unreasonable.

Please call _____ if you have any further questions.

BETHANY INGWALSON
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CC:INTL:B3

⁵FrenchHybrid has never recognized income for U.S. tax purposes.