**Securities Industry Association**
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October 16, 2006

Associate Chief Counsel (International), Branch 3 (CC:INTL:B03)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20044

Attention: Richard L. Chewning, Senior Counsel

Re: Chief Counsel Advisory Regarding Manufactured Overseas Dividends

Dear Sir/Madam:

On February 16, 2006, the Internal Revenue Service issued a Chief Counsel Advisory (the "**CCA**") relating to U.K. manufactured overseas dividends ("**MODs**").[1] In particular, the CCA addressed the use of a special offset mechanism under which a U.K. subsidiary of a U.S. financial services company utilized foreign dividend withholding tax that it suffered to offset a U.K. withholding tax payable in respect of outbound MOD payments that it made, at the cost of not claiming a foreign tax credit for the dividend withholding tax against its U.K. corporation tax liability. The first conclusion of the CCA was that the amount of the subsidiary's U.K. corporation tax for which a U.S. foreign tax credit could be claimed had to be reduced by the amount of the offset, pursuant to the noncompulsory payment rule of Treasury regulations section 1.901-2(e)(5). In addition, the CCA concluded that the use of the offset mechanism caused the foreign dividend withholding tax not to be a qualified tax creditable under section 901(k)(4) to the extent of the offset.[2] The taxpayer's position, on the other hand, was that it was entitled to a U.S. foreign tax credit for the full amount of the subsidiary's U.K. corporation tax as well as the full amount of the foreign dividend withholding tax.[3]

This letter comments on the CCA on behalf of the Securities Industry Association (the "**SIA**").[4] In this regard, the SIA recognizes that the CCA is a case-specific analysis rather

[1] IRS Chief Counsel Advisory 200622044, 2006 *TNT* 107-81 (June 5, 2006).

[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended.

[3] Stated another way, if the subsidiary paid U.K. corporation tax of $100, suffered $10 of foreign dividend withholding tax, and used all of the foreign dividend withholding tax to offset a $10 MOD withholding tax payable, the taxpayer's position was that it was entitled to a total U.S. foreign tax credit of $110 ($100 of U.K. corporation tax plus $10 of foreign dividend withholding tax), while the conclusion of the CCA was that the taxpayer was entitled to a total U.S. foreign tax credit of $90 ($100 of U.K. corporation tax, plus $10 of foreign dividend withholding tax, minus $10 of U.K. corporation tax disallowed under the noncompulsory payment rule and $10 of foreign dividend withholding tax disallowed under section 901(k)(4)).

[4] The Securities Industry Association brings together the shared interests of almost 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in

than a public pronouncement. The issues discussed in the CCA are of concern to the SIA's members, however, and a number of those members have previously considered the U.S. federal income tax analysis of the fact pattern addressed in the CCA.

As discussed in more detail below, the SIA believes that it is not appropriate to apply either the noncompulsory payment rule or the disallowance rule for non-qualified taxes under section 901(k)(4) to the fact pattern addressed in the CCA.[5] Moreover, applying both rules in tandem leads to a double disallowance, which inappropriately reduces the taxpayer's total creditable foreign tax in respect of the subsidiary below the level of foreign tax that the subsidiary actually incurred, and below the level that would have been creditable if the subsidiary had not used the offset mechanism, and had instead simply taken the economically equivalent path of claiming a foreign tax credit against its U.K. corporation tax liability for the foreign dividend withholding tax and using the proceeds of that credit to satisfy the MOD withholding tax payable.

Consistent with the above conclusion, the SIA believes that a more sensible analysis of the offset mechanism would be as a deemed use of the foreign dividend withholding tax to claim a foreign tax credit against the subsidiary's U.K. corporation tax liability, coupled with a deemed use of the proceeds of that credit to satisfy the subsidiary's MOD withholding tax payable. Under this analysis, the amount of the subsidiary's U.K. corporation tax for which a U.S. foreign tax credit could be claimed would still be reduced by the amount of the offset, but the full amount of foreign dividend withholding tax would remain a qualified tax creditable under section 901(k)(4).[6]

## I. BACKGROUND.

The CCA concerns a U.S. corporation ("**Taxpayer**") that was engaged in the financial services business, directly and through a wholly owned U.K. corporate subsidiary

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the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and $474 billion in global revenues. (More information about SIA is available at: www.sia.com ( http://www.sia.com/ ).

5 The first view is consistent with the analysis of at least one other commenter. *See* Matthew A. Stevens, "IRS Says U.K. Tax Not Compulsory, But Taxpayers Need Not Agree," 112 *Tax Notes* 1157 (Sept. 25, 2006).

6 As an alternative, the SIA believes that it would also be consistent with the purpose of the noncompulsory payment rule not to reduce the subsidiary's creditable U.K. corporation tax so long as the subsidiary voluntarily designated the foreign dividend withholding tax as a noncreditable tax, because there would be no increase in the total amount of the subsidiary's creditable foreign tax as compared to the amount that would have been creditable if the subsidiary had not used the offset mechanism. Under either analysis, the taxpayer in the previous example would be entitled to a total U.S. foreign tax credit of $100, composed either of $90 of U.K. corporation tax and $10 of foreign dividend withholding tax, or simply $100 of U.K. corporation tax, which would be the same amount that would have been creditable if the subsidiary had not used the offset mechanism.

("**Subsidiary**"). As part of that business, Subsidiary purchased and borrowed shares of companies resident in various foreign countries other than the United Kingdom.

In connection with foreign shares that it had purchased, Subsidiary received dividends and suffered foreign dividend withholding tax on those dividends. In connection with foreign shares that it had borrowed, Subsidiary made payments in lieu of dividends to U.K. lenders, which are known in the United Kingdom as "manufactured overseas dividends" or "MODs," and was required to withhold and pay over to the U.K. government a U.K. tax in respect of such MODs. In general, the MOD withholding tax is equal to the foreign dividend withholding tax that would have been imposed by the foreign jurisdiction if the underlying dividend had been paid directly to a U.K. recipient. The payer of a MOD must issue to a U.K. recipient of the MOD a voucher that documents the amount of MOD withholding tax deducted, which the U.K. recipient may use as a credit against its U.K. net income tax liability.[7]

Under applicable U.K. tax regulations, the payer of a MOD may apply a foreign dividend withholding tax that it has suffered to offset a MOD withholding tax payable, at the cost of foregoing its ability to use such foreign dividend withholding tax as a foreign tax credit against its U.K. corporation tax liability (the "**Offset Mechanism**"). For purposes of the voucher described above, MOD withholding tax settled by use of the Offset Mechanism is treated the same as MOD withholding tax paid in cash. Subsidiary, through use of the Offset Mechanism, applied a substantial portion of the foreign dividend withholding tax that it suffered in respect of foreign shares that it had purchased to offset its MOD withholding tax liability in respect of other foreign shares that it had borrowed.

With respect to the years at issue, Taxpayer asserted that it was entitled to U.S. foreign tax credits under sections 902 and 960 for the full amount of Subsidiary's U.K. corporation tax, as well as the full amount of the foreign dividend withholding tax suffered by Subsidiary. With respect to the latter, Taxpayer asserted that the foreign dividend withholding tax satisfied the requirements of section 901(k)(4), and that Subsidiary was accordingly exempt from the unhedged holding period requirement of section 901(k)(1) with respect to the shares underlying such tax.[8]

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7 As a consequence, it is clear that the MOD withholding tax is treated as a tax imposed on the recipient of the MOD for U.K. tax purposes. The basis for the MOD withholding tax is contained in paragraph 4(2) of Schedule 23A to the U.K. Income and Corporation Taxes Act 1988 (the "**Act**"). This paragraph provides for a MOD to be treated for all relevant purposes as an "annual payment" within section 349 of the Act. Section 349(1) imposes a general obligation on companies making annual payments to deduct from such payments a sum representing the amount of U.K. income tax on the payments. The payer must then account for that income tax. For U.K. tax purposes, tax deducted from annual payments (or indeed any other categories of payments subject to deduction on account of U.K. income tax under other provisions of section 349 of the Act, including payments such as interest) is treated as income tax borne by the recipient. For example, the ability to claim a credit for the income tax against corporation tax assessable on a recipient of the payment is provided under section 7(2) of the Act; this section applies where "a company resident in the United Kingdom receives any payment *on which it bears income tax* by deduction" (emphasis added).

8 Section 901(k)(1) provides that taxpayers generally may claim credits for taxes withheld from dividend income only if they have held the underlying shares (and have not entered into proscribed hedging transactions) for a period of at least 16 days that includes the ex-dividend date. An exception to this

The CCA concluded that (i) Subsidiary's utilization of foreign dividend withholding tax under the Offset Mechanism rather than as a foreign tax credit against its U.K. corporation tax liability caused a corresponding portion of its U.K. corporation tax to be noncompulsory for purposes of Treasury regulations section 1.901-2(e)(5);[9] and (ii) Subsidiary's utilization of the foreign dividend withholding tax under the Offset Mechanism rather than as a foreign tax credit against its U.K. corporation tax liability caused the foreign dividend withholding tax not to be a qualified tax under section 901(k)(4) to the extent of the offset, because the United Kingdom did not "allow a credit against its net basis tax for the full amount" of the foreign dividend withholding tax, as required by section 901(k)(4)(B)(ii). As a consequence, the CCA concluded that Taxpayer could not claim a U.S. foreign tax credit under sections 902 or 960 for (i) the portion of Subsidiary's U.K. corporation tax that would have been eliminated if Subsidiary had used the full amount of the foreign dividend withholding tax as a foreign tax credit against its U.K. corporation tax liability rather than under the Offset Mechanism; or (ii) the portion of the foreign dividend withholding tax that was used under the Offset Mechanism.

## II. DISCUSSION.

The SIA believes that it is not appropriate to apply either the noncompulsory payment rule or the disallowance rule for non-qualified taxes to the fact pattern addressed in the CCA, although Taxpayer's U.S. foreign tax credit in respect of Subsidiary should be limited to the total amount of foreign tax that would have been creditable in the absence of the Offset Mechanism. Under the facts of the CCA, the Offset Mechanism is simply an administrative convenience that avoids a pointless cash circle. As a consequence, Subsidiary's decision to use or not to use the Offset Mechanism should not lead to substantially different U.S. foreign tax credit results. Applying both disallowance rules in tandem, however, produces just such a difference.

Consider the following two scenarios. In each, Subsidiary (i) has $100 of U.K. corporation tax liability, before considering a potential U.K. foreign tax credit for foreign dividend withholding tax; (ii) has made estimated U.K. corporation tax payments of $100; (iii) has suffered $10 of foreign dividend withholding tax in respect of dividends on German equities held in the ordinary course of its dealer business for short periods around ex-dividend dates that do not satisfy section 901(k)(1); and (iv) is required to withhold $10 on MODs paid in respect of French equities borrowed from a U.K. securities lender and sold short.

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holding period requirement is available under section 901(k)(4), which applies to "qualified taxes" suffered in respect of shares held in the active conduct in a foreign country of a business as a securities dealer. A qualified tax for this purpose is a tax paid to a foreign country, other than the country in which the securities dealer business is located, if the dividend is subject to taxation on a net income basis in the country of receipt and that country "allows a credit against its net basis tax for the full amount of the tax."

9 Treasury regulations section 1.901-2(e)(5) provides that a payment of foreign tax will be deemed to be voluntary rather than compulsory, and will not give rise to a U.S. foreign tax credit, if the taxpayer does not use reasonable efforts to reduce, over time, its liability for foreign tax.

*Scenario 1*: Subsidiary claims a foreign tax credit against its U.K. corporation tax liability for the full amount of the German dividend withholding tax.[10] As a result, Subsidiary:

(i) receives a refund of $10 from the U.K. government ($100 of estimated U.K. corporation tax payments minus $90 of remaining liability after the U.K. foreign tax credit); and

(ii) pays the U.K. government $10 to settle its MOD withholding tax payable.

*Scenario 2*: Subsidiary uses the Offset Mechanism and offsets its $10 MOD withholding tax payable by the $10 of German dividend withholding tax. As a result, Subsidiary:

(i) receives no foreign tax credit refund from the U.K. government in respect of its U.K. corporation tax; and

(ii) makes no payment to the U.K. government in respect of its MOD withholding tax payable.

The following chart summarizes the cash flows:

| **Items** | **Scenario 1** | **Scenario 2** |
|---|---|---|
| Subsidiary's U.K. estimated corporation tax payments | 100 | 100 |
| Subsidiary's U.K. foreign tax credit | (10) | 0 |
| Net U.K. corporation tax paid by Subsidiary | 90 | 100 |
| MOD withholding tax paid by Subsidiary | 10 | 0 |
| Total cash paid to U.K. government by Subsidiary | 100 | 100 |
| German tax withheld on dividends paid to Subsidiary | 10 | 10 |
| Total cash paid by Subsidiary to foreign governments | 110 | 110 |
| U.K. securities lender's credit for MOD tax voucher[11] | (10) | (10) |
| Net cash collected by foreign governments from payments by Subsidiary on its own behalf | 100 | 100 |

From an economic perspective, there is no difference between the two scenarios; Scenario 2 simply eliminates a circular payment of cash from the U.K. government to Subsidiary and then back to the U.K. government. Under Scenario 1, Subsidiary suffers $100 of total foreign tax (i.e., $100 of estimated U.K. corporation tax payments, minus $10 of U.K. corporation tax refunded as a result of the U.K. foreign tax credit, plus $10 of German dividend

[10] The CCA assumes that the foreign dividend withholding tax could in fact have been used to reduce Subsidiary's U.K. corporation tax liability under the United Kingdom's foreign tax credit mechanism, and we make the equivalent assumption for purposes of this letter. Other scenarios could of course require different analyses.

[11] Assuming that U.K. securities lender would otherwise have paid this amount of tax.

withholding tax),[12] all of which should be creditable for U.S. foreign tax credit purposes. It is accordingly reasonable to expect that Scenario 2 would also result in a total U.S. foreign tax credit of $100.

Contrary to this expectation, the analysis presented in the CCA would conclude that Scenario 2 only gives rise to a U.S. foreign tax credit of $90. The reason for this anomalous result is that the CCA's analysis would effectively punish Subsidiary twice for the single sin of using the Offset Mechanism rather than directly claiming a U.K. foreign tax credit in respect of the $10 in German dividend withholding tax: first under the noncompulsory payment rule, and then again under section 901(k)(4). The SIA believes that this double disallowance is unwarranted, because it puts Subsidiary in a different U.S. foreign tax credit position based on an insubstantial decision to utilize the Offset Mechanism rather than to engage in the cash circle of Scenario 1.

As an alternative to the analysis presented in the CCA, the SIA believes that it would be more sensible to view the Offset Mechanism as a deemed use of foreign dividend withholding tax to claim a foreign tax credit against Subsidiary's U.K. corporation tax liability, coupled with a deemed use of the proceeds of that credit to satisfy Subsidiary's MOD withholding tax payable. Under this analysis, use of the Offset Mechanism would not affect the creditability, for U.S. federal income tax purposes, of the foreign dividend withholding tax under section 901(k)(4).

Pursuant to the Offset Mechanism, a MOD payer forfeits the ability to claim a foreign tax credit against its U.K. corporation tax liability, in exchange for the elimination of an equivalent payable to the U.K. government in respect of MOD withholding tax. The recipient of the MOD, however, is treated the same as if the MOD withholding tax were paid in cash, and is still able to reduce its U.K. net income tax liability by the amount of the MOD withholding tax.[13] Because the Offset Mechanism requires the MOD payer to forfeit a foreign tax credit against its U.K. corporation tax liability, it is effectively a use of that credit under the facts of the CCA. Because the Offset Mechanism relieves the MOD payer of an obligation to make a payment to the U.K. government, it is effectively the same as an offsetting payment by the U.K. government

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[12] Although the CCA suggests otherwise, we note in this regard that, from a U.S. as well as a U.K. tax perspective, the MOD withholding tax should be viewed as a tax imposed on the recipient of the MOD, for which the MOD payer merely acts as withholding agent. *See, e.g.,* Proposed Treasury regulations sections 1.901-2(f)(1)(i), (f)(1)(ii), and (f)(6) Examples 1, 4, and 5 (all confirming that, in the case of a withholding tax, the person that is considered under foreign law to earn the income on which the tax is imposed is the person that is considered to suffer the tax for U.S. foreign tax credit purposes); *see also Continental Illinois Corporation v. Commissioner*, 998 F.2d 513, 518-19 (7th Cir. 1993); *Nissho Iwai American Corporation v. Commissioner*, 89 T.C. 765, 773-74 (1987) (both treating a foreign withholding tax as a tax imposed on the recipient of the payment from which the tax was deducted for U.S. foreign tax credit purposes).

[13] The MOD withholding tax voucher, on essentially the same form as is used for cash payments of other U.K. withholding tax, constitutes evidence of payment that satisfies the requirements of section 905. A U.S.-related recipient of such a voucher typically would take account of the taxes paid on its behalf in determining its U.S. foreign tax credits. The "deemed refund" approach described in this letter would assure parallel treatment of payers and recipients of MODs, and thereby would preclude opportunities for the proliferation of multiple claims to foreign tax credits in respect of a single underlying foreign tax payment.

to the MOD payer. Taking account of these two inherent features of the Offset Mechanism, the SIA believes that it would be more sensible to treat the Offset Mechanism under the facts of the CCA as a deemed use of the forfeited foreign tax credit to obtain a refund of U.K. corporation tax to Subsidiary, which is then used by Subsidiary to satisfy its MOD withholding tax payable.[14]

Under the "deemed refund" approach, use of the Offset Mechanism would still result in a reduction in Subsidiary's creditable U.K. corporation tax by the amount of the MOD withholding tax offset, because Subsidiary would be deemed to have received a refund in that amount. Because the United Kingdom would be deemed to have allowed a full credit for the foreign dividend withholding tax, however, use of the Offset Mechanism would not cause any of the foreign dividend withholding tax to be treated as a non-qualified tax under section 901(k)(4)(ii)(B). As a consequence, Taxpayer would be entitled to claim a U.S. foreign tax credit for the same amount and type of foreign tax under Scenario 2 as under Scenario 1 (i.e., $100 of estimated U.K. corporation tax payments, minus $10 of U.K. corporation tax deemed refunded as a result of the Offset Mechanism, plus $10 of German dividend withholding tax).[15] By treating Scenario 2 as a deemed occurrence of Scenario 1, the deemed refund approach would achieve appropriately consistent outcomes, and would eliminate what would otherwise be a pointless incentive to seek a refund of U.K. corporation tax for the sole purpose of immediately repaying the refunded amount to the U.K. government. Stated another way, if Subsidiary can always avoid the negative effects of Scenario 2 by engaging in the cash circle inherent in Scenario 1, there would seem to be little point to treating the scenarios differently.[16]

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14 The SIA does not believe that the Offset Mechanism could plausibly be treated as a refund to Subsidiary of the MOD withholding tax, because settlement of a payable in respect of MOD withholding tax through the Offset Mechanism is otherwise treated, for all relevant U.K. tax purposes, identically to a payment of MOD withholding tax in cash. The recipient of a MOD will indeed generally have no idea whether a given MOD withholding tax was settled in cash or through the Offset Mechanism. In addition, the SIA does not believe that the Offset Mechanism could plausibly be treated as a refund of foreign dividend withholding tax, because the foreign jurisdiction will have collected the full amount of dividend withholding tax and will have no knowledge that its tax may have been used under the Offset Mechanism.

15 We note in this regard that the deemed refund approach is consistent with the policy of section 901(k)(4). In general, the holding period requirement of section 901(k)(1) is designed to prevent U.S. taxpayers from effectively purchasing foreign tax credits by acquiring foreign shares for short periods around ex-dividend dates and voluntarily suffering foreign dividend withholding tax in respect of dividends paid on those shares. *Cf. Compaq Computer Corporation v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999). Consistent with that purpose, the rationale of section 901(k)(4) is that the targeted abuse is unlikely in a circumstance where a foreign dividend withholding tax may be claimed as a credit against a foreign net income tax, because incurring the foreign dividend withholding tax effectively results in an equivalent reduction in creditable foreign net income tax. As outlined above, the deemed refund approach would not result in an increase or reduction in the net amount of Subsidiary's foreign tax that would be creditable for U.S. foreign tax credit purposes. As a consequence, the deemed refund approach would not result in the sort of increase in foreign tax credits that section 901(k)(1) was designed to address.

16 As an alternative to the deemed refund approach, the SIA believes that it would also be consistent with the purpose of the noncompulsory payment rule not to reduce Subsidiary's creditable U.K. corporation tax so long as Subsidiary voluntarily designates the foreign dividend withholding tax as a noncreditable tax, because there would in that case be no increase in the total amount of Subsidiary's creditable foreign tax as compared to the amount that would have been creditable if Subsidiary had not used the Offset Mechanism. The purpose of the noncompulsory payment rule is to ensure that the U.S. foreign tax credit does not have

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Thank you for your consideration of our views. Please do not hesitate to contact me (at 202-216-2031 or pmcclanahan@sia.com) or Kristof Hess of Cleary Gottlieb Steen & Hamilton LLP, SIA's outside counsel on this matter (at 212-225-2638 or khess@cgsh.com), if we can be of assistance with respect to any aspect of your ongoing work.

Sincerely,

Patricia McClanahan
Securities Industry Association

cc: Steven Musher
Hal Hicks
Barbara Felker
John Harrington
Bethany Ingwalson

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the effect of subsidizing voluntary contributions to foreign governments. As a consequence, the noncompulsory payment rule should not be implicated by an isolated increase in foreign tax, and should only be invoked where there is a net increase in the foreign tax for which a U.S. foreign tax credit may be claimed. *See*, *e.g.*, Treasury regulations section 1.901-2(e)(5)(i) (in determining whether a tax is compulsory, "[a] settlement by a taxpayer of two or more issues will be evaluated on an *overall* basis, not on an issue-by-issue basis") (emphasis added). Because of the lack of current clarity regarding the proper analysis of the Offset Mechanism, the SIA recommends that a financial services taxpayer in the situation described in the CCA be allowed to apply either the "deemed refund" approach or the "voluntary designation" approach, so long as the taxpayer does so consistently and until such time as the Service should adopt the deemed refund approach in prospective published guidance. As a consequence, the SIA believes that Taxpayer should ultimately be able to claim a $100 U.S. foreign tax credit under Scenario 2, either as $100 of U.K. corporation tax or as $90 of U.K. corporation tax plus $10 of German dividend withholding tax.