REPORT #903

TAX SECTION

New York State Bar Association

Letter on Proposed Regulations on Documentation of Claim for Foreign Tax Credit

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May 21, 1997

Honorable Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3120
Washington, DC 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Secretary Lubick and Commissioner Richardson:

This letter sets forth our comments on the Notice of Proposed Rulemaking dated January 10, 1997 (REG-208288-90) setting forth certain revisions to Treasury Regulation Section 1.905-2. We commend the Treasury Department and Internal Revenue Service for the decision to permanently eliminate the requirement that documentation supporting a claimed foreign tax credit be submitted with the tax return, as opposed to upon request.

The Notice also proposes to add two sentences (the "Proposed Addition") to current Treasury Regulation section 1.905-2(b)(3), dealing with foreign taxes withheld at source. The Proposed Addition would provide that, upon demand by the district director, a taxpayer must prove that any withholding tax for which a

foreign tax credit is claimed was actually paid to the foreign country. We urge you to revise Section 1.905-2 to permit the district director to require direct, rather than secondary, evidence of payment only in situations in which it is reasonable to believe that the taxpayer could obtain such evidence (and not, for example, in the case of portfolio investors holding foreign stocks and securities through brokerage accounts). Our reasons for this are as follows: (i) for typical portfolio investors, compliance with the evidentiary standard of proof of payment is impracticable if not impossible, (ii) the Proposed Addition would create a circularity to the regulation and exacerbate uncertainty as to whether a foreign tax credit is allowable in circumstances where, under a reasonable balancing of administrative concerns and commercial realities, the credit should clearly be allowed, which uncertainty might ultimately affect investment decisions, and (iii) the Proposed Addition is not compelled by judicial interpretations of and the policies underlying Section 905(b) of the Internal Revenue Code of 1986, as amended (the "Code").

The Existing Regulation

In general, Section 1.905-2(a)(2) requires that a taxpayer provide a receipt for taxes paid or, in the case of accrued taxes, the return on which the accrued taxes were based. Section 1.905-2(b) recognizes the fact that it is impractical if not impossible for a typical portfolio investor in foreign stock or securities to obtain a receipt for foreign taxes withheld at the source from dividends or interest, as is required under Section 1.905-2(a)(2) for foreign taxes generally. Specifically, the first sentence of Section 1.905-2(b) provides that, if the taxpayer cannot furnish a receipt, a foreign tax return, or "direct evidence of the amount of tax withheld at the source," then the district director may accept secondary evidence of withholding in accordance with Section 1.905-2(b)(3). That section provides:

> (3) In the case of taxes withheld at the source from dividends, interest, royalties, compensation, or other form of income, where evidence of withholding and of the amount withheld cannot be secured from those who have made the payments, the district director may, in his discretion, accept secondary evidence of such withholding and of the amount of the tax so withheld, having due regard to the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved.

Such "secondary evidence" could include, e.g., IRS Form 1099-DIV, which is provided to a U.S. holder by a broker and which includes (on line 3) the amount of foreign taxes paid on the holder's behalf. See generally Treas. Reg. § 1.6042-2(a) (requiring brokers to report the amount of dividends and foreign taxes paid with respect to the dividends); Prop. Reg. § 1.6042-3(b) (clarifying that "dividend" includes payments by foreign corporations). The acceptability of other secondary evidence would depend upon the facts and circumstances. See generally Norwest Corp. v. Commissioner, 70 T.C.M. (CCH) 779 (1995).

The Proposed Addition

The Proposed Addition consists of two sentences that would be added at the end of Section 1.905-2(b)(3):

> Any foreign tax credit claimed for taxes withheld at the source is an interim credit and the taxpayer must prove that any taxes withheld at the source were paid to the foreign country, as required in paragraph (a) of this section. The preceding sentence is effective the date that is 30 days after the date this regulation is published in the Federal Register as a final regulation, however, for periods prior to the date that is 30 days after the date this regulation is published in the Federal Register as a final regulation, see Continental Illinois Corp. v. Commissioner, T.C. Memo. 1991-66, 61 T.C.M. (CCH) 1916, 1939-42 (1991), aff'd in part and rev'd in part, 998 F.2d 513, 516-17 (7th Cir. 1993), wherein the court upheld this rule as a reasonable interpretation of section 905(b) of the Internal Revenue Code.

In addition, the proposed revision to paragraph (a)(2) would expressly refer to tax "withheld." Pursuant to the Proposed Addition, if requested by the district director, a portfolio investor in foreign stocks or securities would have to prove that the tax withheld was actually paid to the foreign country. This charge would take the level of proof required an additional step beyond that of the existing regulations, under which an investor must provide primary evidence of the amount of tax withheld unless the district director permits the use of secondary evidence[1]

The Proposed Addition refers to paragraph (a) of Section 1.905-2 for the type of proof required, namely, a receipt for the tax payment. See Treas. Reg. § 1.905-2(a)(2). Although not expressly stated, it appears that the paragraph (a)(2) exception for cases in which "it is established to the satisfaction of the district director that it is impossible for the taxpayer to furnish such evidence"[2] is also intended to temper the proof required under the Proposed Addition. Even if that is the case, the Proposed Addition's reference back to paragraph (a), coupled with the reference to paragraph (b)(3) in paragraph (a)(2), creates a circularity in the regulations that is difficult to reconcile (and which undercuts the purpose of the secondary evidence rule). Thus, the Proposed Addition reinforces what we believe to be a deficiency in existing Section 1.905-2, namely the requirement that any taxpayer, including a

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[1] The Conference Report to the Tax Reform Act of 1986, Pub. L. 99-514, expresses disapproval of the rule of Lederman v. Commissioner, 6 T.C. 991 (1946), under which payment of foreign tax could be proved by the act of withholding. The conferees, however, clearly had in mind situations involving foreign source interest income received by banks and other non-portfolio holders. The Lederman rule has been rejected in recent decisions involving interest derived by banks. See, e.g., Continental Illinois Corp. v. Commissioner, 61 T.C.M. (CCH) 1916 (199 n. aff'd in part and rev'd in part, 998 F.2d 513 (7th Cir. 1993).

[2] For example, in the Continental Illinois case, the IRS would have accepted copies of checks or other evidence directly linking payments to the foreign tax liability.

small portfolio investor in foreign stock or securities, who wishes to avoid dependency on the reasonableness of the district director, must obtain a receipt (or its equivalent) for the payment of taxes withheld at the source on dividends, interest, etc. (or, under the existing regulations, direct evidence of the amount of tax withheld) and maintain it in his or her records, to be produced in the event that the district director requests it.

Reasons for Revising the Proposed Addition

A requirement that proof of payment of foreign taxes be produced represents an onerous burden for the typical portfolio investor in foreign securities. Such an investor receives dividends and interest through an extended chain of intermediaries. The typical portfolio investor is so far removed from the actual payor of the foreign taxes that obtaining a receipt for taxes paid cannot be done as a practical matter. Indeed, it is generally understood that most foreign governments do not even provide such receipts. In others, a tax return might have to be filed. Thus, compliance by typical portfolio investors with a requirement to provide a receipt evidencing payment of the foreign tax, or even direct evidence of the amount of tax withheld, is at best impractical and often impossible.

Moreover, the status of a foreign tax credit attributable to taxes withheld at the source from dividends, interest, etc. as an “interim credit” would increase uncertainty in circumstances where no such uncertainty should exist. For example, suppose that an investor receives dividends on foreign stock from which foreign taxes withheld at the source were actually paid but cannot obtain a receipt for the payment of the tax (or any evidence). Allowance of a foreign tax credit would not impinge on reasonable concerns of tax administration. Under existing Section 1.905-2, the district director is accorded, on the face of the regulation, broad discretion as to whether to permit even portfolio investors to rely on secondary evidence. The Proposed

Addition would exacerbate this problem by expressly describing the foreign tax credit as an “interim credit” subject to adjustment or disallowance and creating the circularity referenced above. While the district director's discretion to disallow a credit ultimately is subject to review under an “abuse of discretion” standard, that standard is very high and creates unnecessary uncertainty in the context of portfolio investments, which might even adversely affect decisions whether to invest in foreign stock and securities.

We recognize that the apparent motivation for the Proposed Addition is to clarify the relationship between Sections 1.905-2(a)(2) and 1.905-2(b)(3), and to forestall any argument that Section 1.905-2(a)(2) has no application to withholding taxes. However, the effect of the Proposed Addition as worded would be to suggest (unfairly we think) that a district director may demand proof from a typical portfolio investor claiming foreign tax credits for withholding taxes that such taxes have been paid to the foreign government. In fact, the possibility that the rule of the Proposed Addition would apply to all taxpayers highlights the analogous deficiency existing under current law.

The Proposed Addition cites the Continental Illinois case as supportive authority. There, the taxpayer, a U.S. bank, received interest that was subject to foreign withholding taxes on loans extended to foreign persons. The Tax Court held that the taxpayer was not entitled to foreign tax credits because it failed to provide the Internal Revenue Service with “proof of actual payment of the withheld tax to the foreign government.” Continental Illinois, supra, 61 T.C.M. (CCH) at 1942. In its reasoning, the Tax Court noted that “[i]n the last 10 years, the petitioner should have been able to provide the respondent with evidence of payment of the withheld taxes.” Id.

The facts of Continental Illinois are easily distinguishable from the situation of the typical portfolio investor. The critical assumption underlying the holding in Continental

Illinois is that the taxpayer, who was in direct contact with the actual payor of the withholding taxes, could have readily obtained the required receipts for the tax payments. As discussed above, this assumption would clearly not hold with respect to the typical portfolio investor.

While the Continental Illinois decision may have reasonably interpreted Code Section 905(b) as applied to the facts addressed therein, and the Proposed Addition may set forth a reasonable rule for similar factual situations, we believe that Section 1.905-2 should be revised to permit the district director to require direct, rather than secondary, evidence of payment only in situations in which it is reasonable to believe that the taxpayer could obtain such evidence (and not, for example, in the case of portfolio investors holding through brokerage accounts). Such an exception should set forth examples of secondary evidence that generally will be considered satisfactory.

I or other representatives of the Tax Section would be pleased to discuss the foregoing with you or your designees at your convenience.

Very truly yours,

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Chair

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