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No Credit for Gross Withholding Taxes on Portfolio Investments?

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To the Editor:

I've read with interest Prof. Michael Knoll's recent piece on *Compaq Computer* (*Tax Notes*, Feb. 12, 2007, p. 679, *Doc 2007-678, 2007 TNT 30-50*) and Michael Schler's letter in response (*Tax Notes*, Mar. 5, 2007, p. 959, *Doc 2007-4930, 2007 TNT 44-43*). As I've written in these pages before ("Some Thoughts on the Incidence of Foreign Taxes," *Tax Notes*, Apr. 24, 2000, p. 541, *Doc 2000-11706, 2000 TNT 79-50*), however, I continue to question whether arguing how best to apply the economic substance doctrine in this particular context should give way to rethinking the creditability of foreign gross withholding taxes on portfolio investments of all kinds.

The shelter in *Compaq Computer* worked because the corporation was able to shift the economic incidence of the foreign gross withholding tax to other actors in the marketplace thanks to the operation of the market. It was still allowed to credit those taxes as long as it agreed to gross up the net dividends received to include them. Every dollar of gross-up would produce a 35-cent tax under a 35 percent tax rate while producing a $1 credit, which produces a 65-cent tax profit for every dollar of tax that it did not economically bear. Because the economic incidence of those taxes was not borne by the corporation, it would hope for ever higher foreign gross withholding tax rates, since every dollar of additional foreign tax would provide the corporation with a 65-cent profit.

Reg. section 1.901-2(f) confirms the general rule that *legal* liability to pay tax, and not economic incidence, governs creditability. Yet we have made at least one statutory inroad on that approach by enacting section 901(i), which denies creditability for a tax that is used by the foreign country to provide a subsidy to the other party to a transaction with the U.S. taxpayer that produced the tax. Thus, when Brazil enacted a program under which Brazilian borrowers would receive a payment from the Brazilian Treasury equal to 85 percent of the foreign gross withholding tax imposed on interest payments made to non-Brazilian lenders, section 901(i) prevented the U.S. lenders from crediting 85 percent of the withholding tax for which they were legally liable. *See Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765 (1987). The assumption underlying the enactment of section 901(i) was that the economic incidence of the tax (to the extent of the 85 percent paid by the Brazilian Treasury to the Brazilian borrowers) would be shifted to the borrowers as the U.S. lenders captured the benefit of the Brazilian subsidy by raising the interest rates charged to those borrowers. The effect of denying the credit is to allow the effective equivalent of a deduction only, because only the net payment will be included in gross income, without a gross-up for the foreign tax that is not creditable.

Say, for example, that a $100 gross interest payment is owed by a Brazilian borrower to a U.S. lender, and a 25 percent withholding tax (for which the U.S. lender is legally liable) of $25 is paid. Of the $25 tax, 85 percent (or $21.25) is paid to the Brazilian borrower by the Brazilian Treasury. While generally we do not care how foreign governments spend the tax dollars they collect from U.S. persons in determining whether the foreign tax is creditable (whether they spend the money on roads and other infrastructure or a big party for the 1,000 best friends of the prime minister), in this case we do. We simply *assume* that the economic burden of $21.25 of the foreign tax was actually borne by the Brazilian borrower (in the form of a higher interest rate than the U.S. lender would otherwise be able to charge) rather than the U.S. lender. For that reason we deny creditability of $21.25 of the $25 foreign gross withholding tax. Because $3.75 will remain creditable, the U.S. lender will gross up its $75 net interest payment to $78.75 and take a foreign tax credit for only $3.75. The portion not credited is effectively only deductible. The U.S. lender would owe a $27.56 tax before credit (under a 35 percent rate), credit $3.75, and owe $23.81 in U.S. tax. The U.S. lender would much rather be allowed to gross up its income inclusion to $100 and take a full $25 foreign tax credit, with a $35 tax due before credit and a full $25 credit, leaving a U.S. tax of only $10. Indeed, as long as it can shift the economic burden of the tax that it nominally paid, it would hope for ever-higher foreign gross withholding tax rates.

> ***Reg. section 1.901-2(f) confirms the general rule that legal liability to pay tax, and not economic incidence, governs creditability. Yet we have made at least one statutory inroad on that approach.***

Of course, U.S. lenders may not be able to capture the benefit of the subsidy to the Brazilian borrowers by raising interest rates, as the machinations of the marketplace (supply and demand) may prevent it. That means the combination of reg. section 1.901-2(f) and section 901(i) is both overinclusive and underinclusive. A foreign tax may be credited, even though it has been economically shifted to others, as long as it is not described in section 901(i) (or section 901(k), enacted in response to cases like *Compaq Computer*). Similarly, a tax credit may be disallowed under section 901(i) or section 901(k) even if the economic incidence of the tax has not been shifted because the market would not allow it.

The withholding tax in *Compaq Computer* was not economically borne by the corporation because it paid a price for the dividend stream in the market that did not reflect the tax. That would be true even if the corporation had held the shares for 16 days, as required under section 901(k) if the withholding taxes are to be creditable today. The holding-period requirement was enacted in a world in which the *Compaq Computer* problem was thought to be one of economic substance, where a common ingredient is very low risk of economic loss on a purchased tax shelter investment. But the risk of economic loss on the underlying investment is not the problem; the problem is that the economic incidence of the tax itself was not borne by the corporation.

Publicly traded foreign stocks and securities very often, as in *Compaq Computer*, do not trade at a price in the United States that reflects the gross withholding taxes that would be due on dividend and interest payments because the market is so heavily saturated with tax-exempt pension funds and other entities that obtain no benefit from a foreign tax credit. Compaq Computer was able to take advantage of that market reality.

I therefore think it wise to reconsider whether gross withholding taxes paid on portfolio investments (like that in *Compaq Computer*) of all sorts should be made noncreditable, regardless of how long the investment is held and without case-by-case litigation under the economic substance doctrine. The foreign tax would then be effectively only deductible (eliminating the 65-cent profit on every dollar of foreign tax nominally paid but not economically borne by the taxpayer), because the recipient would include in gross income only the *net* payment actually received. If a foreign portfolio investment results in a $75 net dividend or interest payment, after a $25 gross withholding tax were withheld from a $100 gross payment, the recipient would include only $75 and be denied a foreign tax credit.

> ***Section 901(k) is a poor response to the real underlying problem. And while the economic substance doctrine is a useful tool in other contexts, the problem is better suited to a broader statutory remedy.***

As Elizabeth A. Owens wrote in her 1961 book *The Foreign Tax Credit* (at p. 83), "the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax." As even Ms. Owens conceded, an individualized determination of whether a particular tax has been economically shifted would not be feasible. But she argued, and Congress has shown in enacting section 901(i), that it is defensible to deny creditability for an entire class of foreign tax when the economic incidence of the tax in that particular context is commonly shifted — even if it is not, in fact, shifted in every single case that may arise. Foreign gross withholding taxes with respect to publicly traded portfolio stock and debt are highly likely not to be borne by the U.S. buyers of those portfolio investments. For this reason, it would be defensible for Congress to consider whether foreign gross withholding taxes on portfolio investments (perhaps less than 10 percent ownership?) should be made entirely noncreditable as a class.

Section 901(k) is a poor response to the real underlying problem. And while the economic substance doctrine is a useful tool in other contexts, the real underlying problem here is better suited to a broader statutory remedy than section 901(k) provides. Surely, foreign gross withholding taxes on portfolio investments are credited every day without challenge under the economic substance doctrine, even though the taxpayer did not economically bear the burden of the tax.

Best wishes,

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March 8, 2007

Preparer Fraud and the Statute of Limitations

To the Editor:

In *Allen v. Commissioner*, 128 T.C. No. 4, *Doc 2007-5704, 2007 TNT 44-11* (Mar. 5, 2007), the Tax Court held that the fraud of an income tax return preparer keeps open the statute of limitations on assessment indefinitely. That conclusion is supported by the language of the statute, section 6501(c), which refers to a "false or fraudulent return" and does not explicitly require fraud on the part of the taxpayer. Also, the principle that statutes of limitation are strictly construed in favor of the government supports the Tax Court's conclusion. FSA 200126019, *Doc 2001-17909, 2001 TNT 127-25*, is directly on point and further supports the court's conclusion.

The opposite conclusion, however, might have been reached. The Tax Court has on at least one occasion applied the same definition of fraud for purposes of the fraud penalty and for purposes of section 6501(c). See *Murphy v. Commissioner*, T.C. Memo. 1995-76, *Doc 95-2155, 95 TNT 33-15* (citing *Asphalt Industries, Inc. v. Commissioner*, 384 F.2d 229, 232 (3d Cir. 1967), *rev'g* 46 T.C. 622 (1966)). Applying the same definition of fraud for statute of limitations and fraud penalty purposes is logical in view of the history of these provisions. Many years ago, a single section of the Revenue Act contained the provisions establishing the fraud penalty and the statute of limitations for a fraudulent return. See Revenue Act of 1918, section 250(b), (d); see also Revenue Act of 1921, section 250(b), (d). By including both provisions in the same section of the Revenue Act, Congress presumably intended that the term "fraud" would have the same meaning for both purposes. See *Commissioner v. Estate of Ridgway*, 291 F.2d 257, 259 (3d Cir. 1961), *nonacq.*, 1960-2 C.B. 8.

Therefore, to resolve the statute of limitations issue in *Allen*, the Tax Court might have considered whether the return preparer's fraud provides a basis for imposing a fraud penalty on the taxpayer under section 6663. One policy underlying the fraud penalty is "to punish and deter wrongful conduct." *Asphalt Industries*, 384 F.2d at 234-235. Based on the policy of punishing and deterring wrongful conduct, it would be improper to impose the fraud penalty based solely on the return preparer's misconduct; the wrongful conduct of the preparer should not have any adverse affect on an innocent taxpayer.

It may be argued that the two provisions (sections 6663 and 6501(c)) should be interpreted consistently in determining whether the requisite fraud is present — taking only the taxpayer's conduct and intent into account — given the history of the two provisions and the presumed congressional intent to give them a parallel interpretation. Thus, the return preparer's fraud cannot be relied on either to impose a fraud penalty on the taxpayer or to keep open the statute of limitations indefinitely. FSA 200104006, *Doc 2001-2586, 2001 TNT 19-46*, is directly on point and supports this alternative approach.

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The writer is retired from the IRS, where he worked on FSA 200104006 and FSA 200126019.