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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR BOBBY SCOTT
INDUSTRY DIRECTOR, NATURAL RESOURCES
LARGE AND MIDSIZE BUSINESS
Attn: Rodney Kobayashi, Territory Manager

FROM: M. Grace Fleeman
Assistant to the Branch Chief, CC:INTL:Br1

SUBJECT: Notice of Withdrawal of Ruling Request of PLR-116607-99 -

In accordance with section 8.07(2)(b) of Rev. Proc. 2000-1, 2000-1 I.R.B. 4, we are providing you with notification of a taxpayer withdrawal of a letter ruling request. On May 15, 2000, Corporation A withdrew its request for a private letter ruling after this office advised Corporation A of its tentatively adverse position. Two rulings were requested on the transaction; following is a brief discussion of the issues, facts, applicable law, and the reasons for this office's tentative adverse position. Corporation A's request is attached. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

## DISCLOSURE STATEMENT

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LEGEND

| | |
|---|---|
| Corporation A | = |
| Corporation B | = |
| Corporation C | = |
| Plan | = |
| Trustee | = |
| Date 1 | = |
| Date 2 | = |
| Date 3 | = |

ISSUES

A. For purposes of the U.S.-U.K. income tax treaty ("Treaty"), will the shareholder and recipient of certain cash dividends to be distributed with respect to American Depositary Shares ("ADSs") held by the Plan be the participants in the Plan ("Participants") or the trust that holds the assets of the Plan ("Trust")?

B. If the Trust is the shareholder and recipient of the dividends and it elects benefits under the Treaty, will the taxes of the Trust that are eligible for the foreign tax credit pass through to the Participants under section 901(b)(5) of the Internal Revenue Code?

CONCLUSIONS

A. The Trust, not the Participants, will be the shareholder and recipient of the dividends.

B. If the Trust elects benefits under the Treaty, the taxes will not pass through to Participants under section 901(b)(5).

FACTS

The ESOP Program. Corporation A adopted the Plan on Date 1 to provide its employees a source of retirement income from a combination of accumulated employee contributions, Corporation A contributions, and investment returns. Corporation A has received a determination letter stating that the plan is qualified under section 401(a). The Trust is exempt under section 501(a).

The Plan includes an employee stock ownership program (“ESOP Program”) that qualifies as an employee stock ownership plan (“ESOP”) under section 4975(e)(7). As of the date of the ruling request, the ESOP Program was invested primarily in Company A stock, as required by the Plan.

Under the Plan, if directed to do so by Corporation A, the Trustee was required to distribute to each Participant any and all dividends payable on the Corporation A shares allocated to his or her ESOP Program account and held on the dividend record date. Corporation A had a standing order in place with the Trustee to distribute all dividends on Corporation A stock held in ESOP Program accounts directly to the Participants. Dividend distributions were required to be paid in cash no later than 90 days after the end of the plan year in which the dividends were received by the Trust. The distributions were reported to the Participants on Form 1099-DIV as taxable dividend distributions.

The merger. On Date 2, Corporation A signed an agreement and plan of merger with Corporation B, a corporation organized under the laws of England and Wales and resident in the United Kingdom for tax purposes. Corporation B subsequently announced its intention to establish a new holding company for the Corporation B group pursuant to a court-approved reorganization in the United Kingdom. Accordingly, on Date 3, the parties executed an amended and restated merger agreement under which Corporation A was to become an indirect, wholly-owned subsidiary of the new holding company, to be renamed Corporation C, and Corporation C was to become a sister company to Corporation A.

In the merger, each share of Corporation A common stock was to be converted into the right to receive a specified number of ADSs representing ordinary shares of Corporation C. The ADSs were to be listed on the New York Stock Exchange.

Each share of Corporation A stock held by the Trust was to be converted to ADSs. After the merger was complete, the Participants' ESOP Program accounts were to hold ADSs. The Trust was to receive cash dividends with respect to the ADSs it held on behalf of the Participants. Corporation A intended to authorize the Trustee to distribute dividends paid with respect to ADSs held in the Participants' ESOP Program accounts directly to the Participants in cash.

The Treaty. Article 10(2) of the Treaty provides that, in the case of dividends paid by a corporation resident in the United Kingdom to a U.S. resident portfolio shareholder, the U.S. shareholder is entitled to a payment from the United Kingdom in an amount equal to the imputation tax credit to which an individual resident in the United Kingdom would have been entitled had he received the dividend, reduced by 15 percent of the sum of the dividend and the tax credit. Under Article 10(2)(a)(iii) of the Treaty, the gross amount of the tax credit is treated as a dividend for United States tax credit purposes. Under Article 23(1)(b), the amount withheld is treated as a creditable tax imposed on the shareholder. Under its domestic law, the United Kingdom does not impose a withholding tax on dividends paid to nonresidents.

After the United Kingdom repealed its advance corporation tax ("ACT") and reduced the imputation credits available to U.K. shareholders effective April 6, 1999, it was unclear whether and to what extent U.S. shareholders would continue to be eligible to claim a foreign tax credit under the Treaty. This uncertainty resulted because the amount permitted to be withheld from the tax credit, which is computed based on the sum of the dividend and the tax credit, completely eliminates the amount payable. Rev. Proc. 2000-13, 2000-6 I.R.B. 1 (January 19, 2000) issued new rules and procedures for applying the Treaty with respect to dividends paid after April 5, 1999. The revenue procedure provides that a U.S. portfolio shareholder may invoke the provisions of Article 10(2)(a) of the Treaty on the receipt of a dividend after April 5, 1999, by filing a Treaty-based return position disclosure form with its tax return. That shareholder will be treated as receiving an additional dividend equal to the gross amount of the tax credit and as paying a withholding tax in the same amount, for which he may claim a foreign tax credit under section 901.

## LAW AND ANALYSIS

### A. The Trust, not the Participants, will be the shareholder and recipient of the dividends and will be entitled to elect Treaty benefits

Under subchapter J (sections 641 through 692), chapter 1 of the Code, amounts distributed to the beneficiaries of a trust have the same character in the hands of the beneficiaries as in the hands of the trust. Code §652(b), §662(b). In other words, subchapter J trusts are conduit trusts. However, the provisions of subchapter J "do not apply to employee trusts subject to Subchapters D and F, chapter 1 of the Code."

Treas. Reg. §1.641(a)-0. Because the Trust is subject to subchapter D, the provisions of subchapter J do not apply to the Trust.

In contrast to subchapter J trusts, employee trusts are not conduit trusts. Amounts distributed to the beneficiaries of an employee trust do not have the same character in the hands of the beneficiaries as in the hands of the trust. Clayton v. United States, 33 Fed. Cl. 628, 644 (1995), aff'd 91 F.3d 170 (1996), cert. denied, 519 U.S. 1040 (1996); Rev. Rul. 72-99, 1972-1 C.B. 115; Rev. Rul. 55-61, 1955-1 C.B. 40. *See also* Rev. Rul. 79-388, 1979-2 C.B. 270. Dividends paid to an employee trust become part of the trust assets and lose their identity as dividends.

There are certain special rules for dividends distributed by an ESOP to its participants. Section 404(k) allows an employer that maintains an ESOP to take deductions for dividends distributed to participants in the ESOP with respect to employer securities held by the ESOP if certain requirements are satisfied. The ESOP is required to report any section 404(k) dividend distributions to the recipients on Form 1099-DIV, and the recipients are required to report the distributions as dividends on their tax returns. However, for any other purpose, the payments must be treated as plan distributions and not as investment income. Announcement 85-168, 1985-48 I.R.B. 40. Therefore, the dividends to be distributed to the Participants with respect to the ADSs held by the Trust must generally be treated as plan distributions and not as dividends.

For purposes of the Treaty, the Trust is the resident of the United States to which the dividends with respect to the ADSs will be paid. The Trust therefore may elect to be treated as receiving an additional dividend and as paying a withholding tax under Article 10(2) and Article 23 of the Treaty. Because the Participants will receive plan distributions from the Trust, not dividends, they will not be entitled to elect Treaty benefits.

B. If the Trust elects Treaty benefits, taxes on the dividends will not pass through to the Participants under section 901(b)(5)

No authorities specifically address the question of whether beneficiaries of employee trusts are entitled to claim under section 901(b)(5) a "proportionate share" of creditable taxes paid by the Trust. It is clear, in the case of subchapter J trusts, that section 901(b)(5) applies to treat the taxes paid by the trust as paid by the trust beneficiaries to the extent the trust's income is passed through and taxable as if earned by the beneficiaries. On the other hand, to the extent the income is not passed through to the beneficiaries and is taxable to the trust, the trust is allowed to claim the credit. Code §642(a). If the grantor or another person is treated as the owner of the trust and is required to take into account in computing his taxable income and credits the items of income, deductions, and credits against tax of the trust, that person is allowed to claim the credit. Code §671.

As noted above, employee trusts are not subject to the rules of subchapter J. However, the statutory scheme that applies to subchapter J trusts suggests that entitlement to the credit is assigned to the beneficiaries only when the beneficiaries are treated as earning the income earned by the trust, that is, the trust is treated as a conduit. Because employee trusts are not conduit trusts, section 901(b)(5) does not allow taxes to be passed through to the beneficiaries.

Please call (202) 622-3880 if you have any further questions.

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