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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: ASSOCIATE AREA COUNSEL

FROM: Steven A. Musher
Chief, CC:INTL:Br6

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated August 9, 1999. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Amount A =

Amount B =

Amount C =

Amount D =

Country A =

State A =

Type A =

Type B =

Taxable Year 1 =

Taxable Year 2 =

Taxable Year 3 =

USCorp =

ISSUES

1. Whether USCorp properly accrued income and deducted expenses with respect to services rendered to its Country A subsidiaries during taxable years in which Country A's laws prohibited companies headquartered there from making payments for services to any person domiciled abroad.

2. Whether USCorp properly accrued and claimed direct foreign tax credits for Country A withholding taxes with respect to the service fee income accrued by USCorp.

3. Whether, for U.S. income tax purposes, USCorp properly characterized as satisfaction of service fee receivables a portion of a payment that was characterized under the laws of Country A as a dividend.

CONCLUSIONS

1. Under the facts of this case, USCorp properly accrued service fee income and deducted related expenses with respect to services that it rendered to its Country A subsidiaries.

2. USCorp cannot accrue and apply direct foreign tax credits prior to the taxable year in which the Country A withholding tax was actually paid.

3. Under the facts of this case, USCorp and the Service may agree, under the terms of a Closing Agreement containing appropriate terms, that a portion of the payment characterized as a dividend under the laws of Country A will be characterized, for U.S. income tax purposes, as satisfaction of service fee receivables.

FACTS

USCorp, a U.S. corporation using the accrual method of accounting, provided Type A and Type B services to its wholly owned Country A subsidiaries during Taxable Years 1 through 3. The laws of Country A prohibited companies headquartered there from making payments for services to any person domiciled abroad during this period.

For U.S. income tax purposes, USCorp accrued and included in its gross income for each of Taxable Years 1 through 3 the compensation[1] due from its

[1] The service fee income included in each Taxable Year by USCorp was equal to USCorp's costs of providing the services. We assume for purposes of this advice that

Country A subsidiaries for the services USCorp rendered in each of those years. (The total amount of Country A service fee income accrued by USCorp for Taxable Years 1 through 3 was $Amount A.) USCorp accrued this income by crediting a service fee income account and debiting a service fee account receivable. USCorp also deducted in each of Taxable Years 1 through 3 its costs of providing the services to its Country A subsidiaries. (The total amount of USCorp's deductions related to Country A service fee income for Taxable Years 1 through 3 was $Amount A.)

USCorp claimed in each of Taxable Years 1 through 3 a section 901 direct foreign tax credit based on an accrual of the Country A withholding taxes that would be due with respect to payments by its Country A subsidiaries of the service fee income accrued each year by USCorp. (The total amount of such Country A foreign tax credits claimed by USCorp for Taxable Years 1 through 3 was $Amount B.) No Country A withholding taxes were actually paid in Taxable Years 1 or 2.

In Taxable Year 3, USCorp's Country A subsidiaries made payments to USCorp that were characterized as dividends under County A law. (The total amount of such payments was $Amount C.) For U.S. income tax purposes, USCorp treated a portion of such payments ($Amount A) as payment of its Country A service fee account receivable for the services it rendered to its subsidiaries in Taxable Years 1 through 3.

Country A withholding taxes were paid with respect to the entire amount of the Taxable Year 3 payments made to USCorp by its Country A subsidiaries. (The total amount of such withholding taxes paid in Taxable Year 3 was $Amount D.) USCorp did not claim a direct foreign tax credit[2] with respect to a portion of such withholding taxes equal to the amount of Country A withholding taxes that USCorp claimed with respect to the Country A service fee income that USCorp accrued for Taxable Years 1 through 3. ($Amount B).

No amendments to USCorp's income tax returns for Taxable Years 1 and 2 were made with respect to this treatment by USCorp of a portion of the Taxable

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these amounts of service fee income were the appropriate arm's length charges for the services USCorp rendered, determined according to Treas. Reg. § 1.482-2(b)(3), which provides that the arm's length charge for services shall, in certain circumstances, be deemed equal to the costs or deductions incurred with respect to rendering such services. We have no information on whether USCorp accrued and included interest income with respect to its service fee accounts receivable.

[2] We understand that USCorp did not claim any section 902 indirect foreign tax credits with respect to the portion of the Taxable Year 3 payment that it treated as satisfaction of service fee receivables.

Year 3 payments received from its Country A subsidiaries as satisfaction of service fee receivables. USCorp reflected this treatment by crediting its service fee income account receivable. Also, USCorp's originally filed return for Taxable Year 3 treated the payments received from its Country A subsidiaries in the first instance, for U.S. income tax purposes, as partly payment in satisfaction of its service fee accounts receivable and as partly dividend income.

Examination has proposed the following adjustments:

1. To disallow USCorp's inclusion of service fee income ($Amount A) and its deduction of service fee costs ($Amount A) in Taxable Years 1 through 3.

2. To disallow USCorp's Taxable Year 3 treatment of a portion of the Taxable Year 3 payments received from its Country A subsidiaries as payment of service fee income accounts receivable for services performed in Taxable Years 1 through 3 ($Amount A) and to require that amount ($Amount A) be reported as additional Taxable Year 3 dividend income.

3. To disallow USCorp's direct foreign tax credits claimed with respect to service fee income in Taxable Years 1 through 3 ($Amount B) and to require that amount ($Amount B) to be reported as additional Taxable Year 3 foreign tax credits attributable to dividend income.

As a result, USCorp's service fee income for Taxable Years 1 through 3 ($Amount A) would be eliminated. Its dividend income for Taxable Year 3 would be increased by the same amount ($Amount A). The foreign tax credits claimed by USCorp for Taxable Years 1 through 3 as attributable to its service fee income ($Amount B) would be eliminated and USCorp's Taxable Year 3 foreign tax credits attributable to Taxable Year 3 dividend income would be increased by an equal amount ($Amount B). These proposed adjustments would not, therefore, change the reported amounts of USCorp's overall gross income or the overall amount of USCorp's direct foreign tax credits for the combined taxable years at issue.

The predominant effect of these proposed adjustments on USCorp's overall taxable income for the taxable years at issue would be the disallowance, for Taxable Years 1 through 3, of USCorp's deductions for its costs of providing services to its Country A subsidiaries ($Amount A) and a corresponding increase in USCorp's taxable income.

LAW AND ANALYSIS

1. USCorp Properly Accrued Service Fee Income And Deducted Related Expenses

As we discuss below, we consider that U.S. income tax principles on the accrual of income allow USCorp, in the circumstances of this case, to accrue service fee income in the amount of the arm's length compensation for services that it provided to its Country A subsidiaries. We do not consider the decision in *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992) (the *P&G* case),[3] to prevent this result.

A taxpayer may select a method of accounting for U.S. income tax purposes, both as an over-all method and an accounting treatment for particular items, provided the method selected clearly reflects income, with all items of gross income and expense treated consistently from year to year. I.R.C. § 446; Treas. Reg. §1.446-1(a). Under the accrual method, income is generally "to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy." Treas. Reg. §1.446-1(c)(1)(ii). In this case, there is no issue regarding the amount of the service fee income.

All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. *See, e.g.*, *Schulde v. Commissioner*, 372 U.S. 128 (1963); *Charles Schwab Corp. v. Commissioner*, 107 T.C. 282 (1996), *aff'd*, 161 F.3d 1231 (9th Cir. 1998), *cert. denied*, 528 U.S. 822 (1999). The issue with respect to USCorp's accrual of service fee income is whether there are circumstances in this case that require USCorp to depart from the general rule of accrual accounting that income is to be accrued when the services are performed, even where payment may not be due or where payment has not occurred.

In particular, the issue is whether Country A's laws prohibiting payments characterized by Country A as service fees to persons domiciled outside of Country A prevent USCorp from having a fixed right to receive income for the services it performed for its Country A subsidiaries. In an early explanation of the all events test for the accrual of income, the Ninth Circuit held that, for a fixed right to receive income to exist, there should be "a reasonable expectancy that the right will be converted into money or its equivalent." *Liebes v. Commissioner*, 90 F.2d 932, 937 (9th Cir. 1937). The issue here may be evaluated in terms of whether USCorp had a reasonable expectancy of receiving payment in money or its equivalent for the services it rendered to its Country A subsidiaries.

Ordinarily, when an uncontrolled taxpayer provides valuable services to another uncontrolled taxpayer, it does so with the reasonable expectation that it will

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[3] USCorp's principal place of business is in State A. If there is litigation in this case before a U.S. District Court or the Tax Court, any appeal would therefore be to the U.S. Court of Appeals for the Sixth Circuit.

receive payment. In this case, USCorp and its Country A subsidiaries are members of a group of controlled taxpayers within the meaning of Treas. Reg. § 1.482-1A(a)(5).[4] This means that USCorp has the power to cause the transactions and accounting records of the members of the group to reflect, for U.S. income tax purposes, the true taxable income of each controlled taxpayer. *See* Treas. Reg. § 1.482-1A(b). The true taxable income is the amount that would have resulted to the controlled taxpayer if it had conducted the transaction at arm's length. Treas. Reg. § 1.482-1A(a)(6). Accordingly, the fact that USCorp provided services to its Country A subsidiaries at a time when Country A's laws were as described indicates that USCorp reasonably expected to be able to receive payment for such services. The fact that USCorp accrued the arm's length compensation for such services as taxable U.S. income reinforces the basis for concluding that USCorp had a reasonable expectancy of receiving payment in money or its equivalent for such services.

We do not view the decision in the *P&G* case to require a conclusion that USCorp could not, as a matter of law, have had such a reasonable expectancy of payment. The *P&G* case involved a Spanish corporation, P&G España S.A. (España), owned by a Swiss corporation, Procter & Gamble A.G. (AG), which was owned, in turn, by a U.S. taxpayer, Procter & Gamble Company (P&G). In approving P&G's request to organize and to own, directly or indirectly, 100 percent of España, the Spanish government stated that España could not pay any amounts for royalty and technical assistance and this prohibition was maintained through the taxable years at issue in the case.

AG paid P&G royalties under a license and service agreement for the use by AG and its subsidiaries, including España, of P&G's intangible property and assistance, based primarily on a percentage of net sales of P&G's products by AG and its subsidiaries. AG entered into similar agreements with and received royalties from its subsidiaries, other than España. España used P&G's intangible property and assistance and sold its products, but did not pay royalties to AG. The Commissioner sought to allocate a royalty of two percent of España's net sales to AG under section 482.

The Sixth Circuit ruled against the Commissioner's attempt to allocate royalty income to AG, stating that "[t]he purpose of section 482 is to prevent artificial shifting of income between related taxpayers. Because Spanish law prohibited royalty payments, P&G could not exercise the control that section 482 contemplates, and allocation under section 482 is inappropriate." *Procter & Gamble Co. v. Commissioner*, *supra*, 961 F.2d at 1259.

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[4] All of the Taxable Years at issue in this case occurred before the current section 482 regulations became effective.

The Commissioner argued that Spanish law allowed the payment of dividends and that the Commissioner would have treated a dividend from España to AG as a royalty for United States tax purposes. *Id*. The court rejected this argument, stating that "[a]ssuming that España had profits from which it could pay a dividend under Spanish law, we find that P&G had no such obligation [to cause España to pay a dividend]." *Id*. The court also stated that it "firmly disagree[d] with the Commissioner's suggestion that P&G should purposely evade Spanish law by [causing España to make] royalty payments under the guise of calling the payments something else." *Id*. The court concluded its rejection of this argument by noting that "the record reflects that España did not have distributable earnings from which to pay dividends;" that it "had accumulated deficits during the years at issue and [was] unable to distribute dividends." *Id*.

The *P&G* case is distinguishable from this case. First, USCorp arranged its affairs so that its accounting records reflected, for U.S. income tax purposes, the true taxable income of the members of its controlled group.

Second, in this case, the taxpayer reasonably anticipated the receipt of payment for the services it provided and it was able, under foreign law, to have its Country A subsidiaries make payments that it treated as payment for the services it had provided. The issue of whether actual payments, characterized under foreign law as dividends, may properly be characterized differently for U.S. income tax purposes was not addressed in the *P&G* case because España had accumulated deficits during the years at issue and was not able to and did not distribute dividends.

Third, under the facts of this case, there is no purposeful evasion of foreign law when payments by a foreign corporation are viewed as dividends under foreign law but are treated as payments in satisfaction of accounts receivable for purposes of U.S. income tax law. We consider that the Sixth Circuit would recognize, as has the Tax Court, that where United States and foreign tax authorities take different views on the application of tax laws to a particular transaction, payments to adjust the tax accounts of controlled taxpayers may well be characterized differently by the respective countries. *See, e.g.*, *Schering Corp. v. Commissioner*, 69 T.C. 579 (1978). In the *Schering* case, the Commissioner increased the income of a U.S. taxpayer and reduced the income of its Swiss subsidiary. *Id*. at 582. The U.S. taxpayer established an account receivable under Rev. Proc. 65-17, 1965-1 C.B. 833, so that it could receive payment of the income allocated to it by the Commissioner without further U.S. tax consequences. The Swiss tax authorities refused to accept the reduction of income deemed by the Commissioner to have resulted to the Swiss corporation from the Commissioner's allocation of income to the U.S. taxpayer. The Swiss tax authorities therefore treated the Swiss subsidiary's payment of the account receivable to its U.S. parent as a dividend subject to a withholding tax under Swiss law. *Id*. at 587.

The Tax Court recognized that the "payment of the accounts receivable was regarded, for United States tax purposes, as the repayment of a bona fide debt," while the payment, under Swiss law, "could be made only in the form of a dividend" subject to withholding tax under Swiss law, and upheld the taxpayers claim of a section 901 foreign tax credit with respect to the payment, even though the Swiss tax was applied to an item that is not taxable under U.S. concepts of income taxation. *Id*. at 590-92.

We note in this regard that the successor to Rev. Proc. 65-17, Rev. Proc. 99-32, 1999-2 C.B. 296, provides that accounts established under the revenue procedure may, under certain circumstances, be treated as offset by distributions, including dividends, and by capital contributions, and that such offsets are treated as payment of interest and principal of an account, for all Federal income tax purposes, regardless of their characterization under foreign law.[5]

Thus, we conclude that USCorp properly accrued income for the services it rendered to its Country A subsidiaries. We do not consider this result to be altered by Country A's legal prohibition on the payment by companies headquartered there of service fees to any person domiciled abroad or by the holding in the *P&G* case.

Based on the foregoing, we also conclude that USCorp's deductions for costs associated with rendering the services in question should be allowed. In the facts of this case, the deduction of such costs in the same taxable years as the services were rendered, and in which the income from the services was included in income, is consistent with the reflection of true taxable income.

2. USCorp Improperly Accrued and Applied Direct Foreign Tax Credits

We agree with Examination's proposed disallowance of USCorp's claimed section 901 foreign tax credits for Taxable Years 1 and 2. We consider that USCorp was wrong to accrue a withholding tax prior to Taxable Year 3, when it paid the withholding tax on the payments characterized as dividends under Country A's laws.

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[5] We also note that in *Commissioner v. First Security Bank,* 405 U.S. 394 (1972), the seminal case on the effect of legal restrictions on the Commissioner's authority to allocate income under section 482, all of the members of the controlled group in question were subject to U.S. law and federal banking law prohibited one member of the group from performing a certain type of service and from receiving compensation for performing such services. There was no question in the *First Security* case as to whether the way in which a payment was characterized under foreign law should prevent a U.S. taxpayer from characterizing the payment according to U.S. income tax principles.

Treas. Reg. § 1. 905-1(a) provides that a foreign tax credit may be taken in the return for the year in which the taxes accrued. Here, under the laws of Country A, withholding taxes were not owed in Taxable Year 1 or 2. Liability for withholding taxes did not accrue until payments were made in Taxable Year 3. The “all events” test for accrual of liabilities of Treas. Reg. §§ 1.461-1(a)(2)(i) and 1.466-1(c)(1)(ii)(B) was not met until Taxable Year 3.

For reasons discussed below, we do not agree with Examination’s proposal that the foreign tax credits must be treated as taxes imposed upon amounts treated as dividend income for U.S. income tax purposes. To the extent that a portion of the Taxable Year 3 payments were properly treated, for purposes of U.S. income tax, as satisfaction of service fee receivables, the taxes would then be treated as imposed on amounts treated as dividends for Country A purposes but as payment of an account receivable for U.S. income tax purposes. Nonetheless, provided that the taxes were legally owed under Country A law, the withholding taxes would be creditable in Taxable Year 3. *See* Treas. Reg. § 1.904-6(a)(1)(i) and (iv).

3. USCorp and the Service May Agree Under a Closing Agreement That a Portion of the Payment Characterized as a Dividend Under the Laws of Country A Will Be Characterized for U.S. Income Tax Purposes as Satisfaction of Service Fee Receivables

We consider that, in the circumstances of this case, USCorp’s treatment of a portion of the Taxable Year 3 payments received from its Country A subsidiaries as satisfaction of service fee receivables effectuates the taxpayer’s compliance with section 482 and the regulations thereunder. We recommend that USCorp be offered the opportunity to enter into a Closing Agreement that would expressly provide for such treatment, subject to appropriate conditions.

A U.S. taxpayer’s proper treatment of items for U.S. income tax purposes may not necessarily conform to their proper treatment under foreign law. *Schering, supra*. U.S. income tax principles are generally concerned that the treatment of a tax item be consistent with its substance. In this case, a portion of the Taxable Year 3 payments are, in substance, payments of receivables for services provided to the Country A subsidiaries. The payments treated by USCorp as reductions of service fee receivables were so treated in the first instance by USCorp, and USCorp had never characterized them differently for U.S. income tax purposes.

In our view, USCorp’s treatment of its Taxable Years 1 through 3 service fee accruals and the portion of the Taxable Year 3 payments represents, in effect, reporting on timely filed U.S. income tax returns of results of its controlled transactions as necessary to reflect an arm’s length result. Such treatment is now expressly provided for by Treas. Reg. § 1.482-1(a)(3), which was not effective for the Taxable Years at issue in this case. However, when this regulation was issued, the Service stated that it was only clarifying the ability of taxpayers to file returns that reflected their true taxable income even if such results differed from transactional results. Intercompany Transfer Pricing Regulations Under Section 482 (Temporary regulations), T.D. 8470, 1993-1 C.B. 90, 92. Thus, the Service considers that taxpayers have always had the ability to properly reflect income on original timely filed income tax returns.

To the extent that such treatment by USCorp is viewed as a taxpayer-initiated use of section 482 to adjust its income and thereafter to conform its accounts to reflect arm's length results, Rev. Proc. 99-32, discussed above, now allows taxpayers to establish accounts receivable or payable, of the kind discussed in the *Schering* case, but without the need for the taxpayer to enter into a Closing Agreement with the Service.

Rev. Proc. 99-32 includes liberal transition rules with respect to the application by taxpayers of revenue procedure treatment (including the establishment of accounts payable or receivable) with respect to taxpayer-initiated adjustments for taxable years preceding the effective date of the revenue procedure. 1999-34 I.R.B. at 296-97. Rev. Proc. 99-32 describes taxpayer-initiated adjustments as those made "pursuant to section 1.482-1(a)(3) of the Treasury regulations." 1999-34 I.R.B. at 296. As noted above, the Taxable Years at issue in this case are before the effective date of Treas. Reg. § 1.482-1(a)(3). But also as noted above, the Service considered that taxpayers always had the ability to make such self-initiated adjustments, even before the issuance of this regulation. However, because the ability of a taxpayer to self-apply revenue procedure treatment is not expressly provided for by Rev. Proc. 99-32 in the case of taxpayer-initiated adjustments that predate the effective date of Treas. Reg. § 1.482-1(a)(3), we consider that the appropriate action to take in this case is to offer the taxpayer an opportunity to enter into a Closing Agreement, consistent with the requirements of Rev. Proc. 65-17.

We note that both Rev. Proc. 65-17 and Rev. Proc. 99-32 require any account receivable established under revenue procedure treatment to bear interest, which must be accrued and included in taxable income of the taxpayer from the time the account is created to the date of payment. Adjustments may therefore be required to the extent that USCorp may not have accrued and included in income the appropriate amount of interest with respect to its service fee income accounts.

Also as required under revenue procedure treatment, the portion of the Taxable Year 3 payments treated as payment of service fee income accounts receivable cannot be treated as dividend income for any U.S. income tax purpose and the sourcing of income and the use of foreign tax credits (section 901 direct credits and section 902 indirect credits) must be accounted for properly.

The Field should determine whether currency gain or loss was realized with respect to the accrual of the income and the subsequent satisfaction of the account receivable. *See* Treas. Reg. § 1.988-2(c). Currency gain or loss would be realized if the accounts receivable were denominated in a currency other than the functional currency of USCorp or of its Country A subsidiaries.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call our branch, at (202) 874-1490, if you have any further questions.

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