ID: CCA_2009040714014556
Office:
UILC: 901.02-00

Number: **200920051**
Release Date: 5/15/2009

From:
Sent: Tuesday, April 07, 2009 2:01:47 PM
To:
Cc:
Subject: Noncompulsory Tax Question

You requested advice whether Taxpayer should be allowed to claim foreign tax credits in a case where an election under Italian law to treat an entity that is a controlled foreign corporation (CFC) for U.S. tax purposes as a partnership for Italian tax purposes results in the U.S. parent of the CFC claiming to incur Italian tax liability for which it claims a foreign tax credit under section 901, even though it doesn't include any of the related income for U.S. tax purposes.

The facts as we understand them are as follows: Taxpayer set up two CFCs in Italy that both made elections to be treated as disregarded entities for U.S. tax purposes (the Italian DEs) but which are still treated as corporations for Italian tax purposes. The U.S. parent of the Italian DEs then contributed its interests in two other Italian CFCs (the Italian CFCs) to the two Italian DEs on a pro rata basis. Soon after, the Italian CFCs that were contributed to the Italian DEs elected fiscal transparency for Italian tax purposes but continued to be treated as corporations for U.S. tax purposes. This election was made by the Italian CFCs but required the consent of all shareholders, in this case the Italian DEs. For Italian tax purposes, the income of the Italian CFCs flows up to the Italian DEs where the tax liability is imposed. However, for U.S. tax purposes, because the Italian DEs are disregarded, the U.S. parent is seen as directly paying the Italian tax liability imposed on the Italian DEs. The income to which the tax liability corresponds remains with the Italian CFCs until it is repatriated, if ever (assuming it is not subpart F income). As a result, Taxpayer claims a significant amount of foreign tax credits for the Italian taxes paid by the Italian DEs without reporting any of the corresponding income from the Italian CFCs.

You may wish to consider challenging the credits on the grounds that the payment of the Italian taxes by the U.S. parent's Italian DEs constitute noncompulsory payments within the meaning of Treas. Reg. § 1.901-2(e)(5) for which Taxpayer is not entitled to claim foreign tax credits. To the extent a taxpayer fails to take advantage of elections under foreign law to minimize its foreign tax over time, the amount by which the foreign tax could have been reduced is treated as a noncompulsory payment. See Treas. Reg. § 1.901-2(e)(5)(i), cited in TAM 200807015 (Nov. 7, 2007) and CCA 200622044 (Sept. 5, 2006). The Italian fiscal transparency election to treat the Italian CFCs as partnerships for Italian tax purposes required 100% shareholder consent. Therefore, it can be argued that the election was a joint election made by the Italian DEs and their wholly-owned CFCs. Because the Italian DEs are disregarded entities, any election made by them is considered made by the U.S. parent, which is treated as having paid tax paid by the DEs. Accordingly, in this case the U.S. parent arguably made an election under Italian law that causes its DEs to be liable for Italian taxes they would not have otherwise been liable for had it not made the election. Because in the absence of the election the Italian CFCs would have been liable to tax, but the Italian DEs would not have been taxable on a subsequent distribution of earnings from the Italian CFCs, the election had the effect of permanently increasing, rather than merely accelerating to an earlier year, the U.S. parent's Italian tax liability. Therefore, the taxes arguably constitute noncompulsory payments for which a foreign tax credit may not be claimed.

Taxpayer may cite Treas. Reg. § 1.901-2(e)(5)(i), which states that "a taxpayer is not required to alter its form of doing business to reduce its liability under foreign law for tax" and claim that the Italian DEs' election to treat the Italian CFCs as partnerships for Italian tax law purposes is a choice of form of doing business and therefore does not result in a noncompulsory payment. This objection is not persuasive. The election was not a choice of form of business. The form of business taxpayer chose was to operate the Italian CFCs and DEs as corporations. Taxpayer then made an election under Italian law to have the CFCs treated differently for Italian tax purposes than their chosen form of business would otherwise require. Because this foreign tax election increased the Italian tax liability of the DEs, taxpayer has failed in its duty to apply the procedural and substantive provisions of foreign law in a way that minimizes its foreign tax liability over time.

This type of election, shifting liability between related entities, would likely be allowable under Prop. Treas. Reg. § 1.901-2(e)(5)(iii) and Notice 2007-95, 2007-2 C. B. 1091 (Nov. 19, 2007) if it were done between two members of a U.S.-owned foreign group, which the proposed regulations treat as a single taxpayer for purposes of the noncompulsory payment rules. However, because the Italian DEs are disregarded for U.S. tax purposes, this case involves shifting tax liability to a U.S. parent from its related CFCs. The U.S. parent and the Italian CFCs are not treated as a single taxpayer by the proposed regulations.

Hazards:

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