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Guardian Industries Highlights Planning Techniques And Tensions In Foreign Tax Credit Area

Guardian Indus. v. U. S. (Fed. Cl. filed Dec. 23, 2002, No. 02-1936T)

Overview

In *Guardian Industries v. U.S.*, currently before the Court of Federal Claims, the taxpayer, Guardian Industries, is defending the use of the "check the box" election to separate foreign tax credits from the foreign income that was subject to tax by the foreign country. The parties recently submitted lengthy briefs to the court in connection with the taxpayer's motion for summary judgment and the case has drawn wide attention because it highlights many issues in the foreign tax credit area that are currently being hotly debated.

Background

The taxpayer in *Guardian Industries* is the common parent of a U.S. consolidated group, which includes Interguard Holding Corp. ("IHC"). IHC owns 100 percent of the stock of Guardian Industries Europe, S.a.r.l. ("GIE"), which is a Luxembourg holding company that owns directly or indirectly substantially all the stock in ten Luxembourg companies. Under the Luxembourg corporate income tax, GIE and its affiliates qualify as a "fiscal unitary group" and they report income on a consolidated basis. Under Luxembourg law, GIE, as the parent corporation of the fiscal unitary group, is arguably solely liable for income tax owed by the group. Each member of the group, however, is required to file its own Luxembourg corporate income tax return and, in fact, makes direct payments of part of the group's income tax to the Luxembourg revenue authorities.

GIE elected to be a disregarded entity under the check the box rules. Thus, for U.S. income tax purposes GIE is an unincorporated division of IHC and IHC is considered the parent corporation of the Luxembourg fiscal unitary group. If GIE – an "unincorporated division" of IHC – is liable for the income tax of the entire group, then for U.S. tax purposes IHC is liable.

Overview of Foreign Tax Credit Rules

I.R.C. § 901 allows a U.S. corporation to take a direct foreign tax credit for foreign income taxes paid or accrued by the U.S. corporation during the taxable year. Under I.R.C. § 902 a U.S. corporation is deemed to pay the foreign income taxes paid by certain direct or indirect 10 percent owned foreign subsidiaries on earnings that are distributed to the U.S. corporation.

Treas. Reg. § 1.901-2(f)(1) elaborates on when a company is considered to "pay" foreign income tax, providing that "the person by whom tax is considered paid … is the person on whom foreign law imposes a legal liability for such tax even if another person (e.g., a withholding agent) actually remits the tax." This rule, known as the "technical taxpayer rule," looks to foreign law to determine legal liability for the tax. The regulations provide that if foreign income tax is imposed on the combined income of a group of affiliated corporations that file a combined or consolidated income tax return under foreign tax law "and they are jointly and severally liable for the income tax under foreign law, then foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax."

The maximum foreign tax credit a taxpayer can claim for a year is equal to the U.S. tax (before taking the foreign tax credit into account) imposed on the taxpayer's foreign source taxable (or

Jack Cummings
Editor

601 Pennsylvania Avenue, N.W.
North Building, 10th Floor
Washington, D.C. 20004-2601
202-756-3300
Fax: 202-756-3333

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continued on back page...

continued from front page...

"net") income. This formula is applied separately to various categories (or baskets) of income, one of which is the general or residual basket. Since each basket contains income from discrete sources, a taxpayer is able to average high taxed foreign source income against low taxed foreign source income within a single basket. There is no requirement that the specific foreign income that was subject to foreign income tax be included in the taxpayer's U.S. income. The pending tax bill, the "American Jobs Creation Act of 2004," would reduce the number of baskets to two, thus increasing opportunities for cross crediting.

The Guardian Case

In *Guardian*, the taxpayer claimed a direct foreign tax credit under I.R.C. § 901 for approximately $3 million of Luxembourg income tax incurred by GIE in 2001 as the parent company of a fiscal unitary group on income realized by other group members even though none of the other group members made distributions to GIE during the year. Since GIE is disregarded as a separate entity for U.S. income tax purposes, the taxpayer took the position that IHC, GIE's owner and a member of its US consolidated group, "paid" the taxes imposed on the income of the fiscal unitary group. Thus, the taxpayer was able to claim foreign tax credits without recognizing any of the underlying income on which the foreign income tax was imposed (none of the income of the lower tier subsidiaries was subject to U.S. income tax because it was not distributed and did not constitute subpart F income). The taxpayer assigned the Luxembourg tax to the general income basket under the foreign tax credit limitation regime and since the taxpayer had an excess foreign tax credit limitation it was able to eliminate U.S. income tax on income from countries other than Luxembourg.

The taxpayer took the position that under the Luxembourg corporate income tax law the parent company of a fiscal unitary group is solely liable for income tax on the group's income even if the subsidiaries make no distributions to the parent. The IRS countered that although Luxembourg law is ambiguous on this point, the better reading is that all members of a unitary group are jointly and severally liable for income tax imposed on the group's income. Consequently, according to the IRS, IHC is only entitled to an I.R.C. § 901 credit to the extent of its pro rata share of the unitary group's 2001 income. Thus, the issue before the court is whether the parent corporation of a fiscal unitary group under Luxembourg corporate tax law is solely or jointly and severally liable along with the other group members for the tax imposed on the income of the group.

Planning Considerations

Even though *Guardian* will likely be decided on a discrete provision of the Luxembourg corporate tax law, we believe the case is significant. It illustrates how the check the box elective entity classification rules may permit separation of foreign income tax from the underlying foreign income. That the result under the foreign tax credit rules turns on a question of foreign law with little apparent practical effect in the foreign country highlights the issue whether the check the box rules are appropriate in the international arena. The case will also influence debates over whether the "technical taxpayer" rule and "cross crediting" of foreign taxes (or averaging foreign source income from different countries in the foreign tax credit limitation regime) should be modified. Finally, the case shows that the IRS is continuing to challenge foreign tax credit planning structures that use disregarded entities.

For additional information contact Eva Farkas-DiNardo (212-210-9562); Andy Immerman (404-881-7532); Sam Kaywood (404-881-7481); or Kevin Rowe (212-210-9505.

International Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404-881-7481

Edward Tanenbaum
Co-Chair
212-210-9425

Pinney L. Allen
404-881-7485

Gideon T. J. Alpert
212-210-9403

Saba Ashraf
404-881-7648

Henry J. Birnkrant
202-756-3319

Bret N. Bogenschneider
404-881-4989

Robert T. Cole
202-756-3306

Philip C. Cook
404-881-7491

James E. Croker, Jr.
202-756-3309

Jasper L. Cummings, Jr.
202-756-3386

Eva Farkas-DiNardo
212-210-9592

Terence J. Greene
404-881-7493

Michelle M. Henkel
404-881-7633

L. Andrew Immerman
404-881-7532

Akemi Kawano
202-756-5588

Andrea Lane
202-756-3354

Brian E. Lebowitz
202-756-3394

Timothy J. Peaden
404-881-7475

Kevin M. Rowe
212-210-9505

Matthew C. Sperry
404-881-7553

Gerald V. Thomas II
404-881-4716

Charles W. Wheeler
202-756-3308

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