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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR TINA BYRD, NATIONAL ADMINISTRATOR, IFASP, AND
JOHN CONLEY, APPEALS OFFICER/ISP COORDINATOR
FOR COMMERCIAL BANKING

FROM: CYNTHIA J. MATTSON
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SUBJECT: UPDATE ON BRAZILIAN FOREIGN TAX CREDIT
LITIGATION -- RIGGS NATIONAL CORPORATION &
SUBSIDIARIES v. COMMISSIONER, 107 T.C. 301 (1996),
REV'D AND REMANDED, 163 F.3d 1363 (D.C. Cir. 1999)

This memorandum updates my May 6, 1997, and January 18, 1995, memorandums regarding Brazilian foreign tax credit litigation. In 1996, the Service won the "Central Bank Restructured Debt" foreign tax credit disallowance issue in the Tax Court litigation of the Riggs case on the theory that the purported Central Bank withholding tax payments were noncompulsory amounts and not a tax to Brazil. Recently, the D.C. Circuit reversed this holding through an application of the act of state doctrine and remanded the case to the Tax Court for a determination of the alternative payment and subsidy theories relied upon by the Service for disallowance of the credits associated with Brazilian restructured debt. We do not agree with the D.C. Circuit's opinion, and further litigation will be required to resolve the "Central Bank Restructured Debt" issue. Pending the outcome of further litigation, we recommend that the Service continue to pursue the "Central Bank restructured debt" issue present in other cases at the administrative level. Additional recommendations regarding other Brazilian foreign tax credit issues are set forth below.

Riggs, a domestic corporation, claimed foreign tax credits for Brazilian taxes on net loan interest payments that Riggs received from Brazilian borrowers. Under the net loans, the borrowers (including the Central Bank of Brazil) assumed responsibility for paying the tax on Riggs' behalf. Although the Brazilian Supreme Court had held that, under Article 19 of the Brazilian Constitution, tax-immune Brazilian governmental entities, like the Central Bank, were not liable to pay withholding tax on their net loan interest remittances to foreign lenders, beginning in 1984, the Central Bank purportedly paid withholding tax on its Brazilian restructured debt.

This event was marked by the Brazilian Minister of Finance's endorsement of a ruling of the Brazilian IRS to the Central Bank regarding the Central Bank's liability. The ruling stated that despite the Central Bank's tax-immune status, the bank was required to pay withholding tax on net loan interest payments made to foreign lenders because the loan amounts on deposit at the Central Bank could be re-lent to other borrowers who might not be tax immune. The Minister of Finance, in the document agreeing with the ruling, directed the Central Bank to implement the payment of income tax on or before the last business day of the month after the month in which the withholding occurs. The ruling and the Minister's order were not published.

In deciding that the foreign tax credits should be disallowed on the theory that the purported payments were noncompulsory, the Tax Court rejected Riggs' argument that the act of state doctrine required deference to the Brazilian ruling and the Brazilian Minister of Finance's order. The Tax Court held that Riggs had failed to show that the ruling was anything more than an administrative advisory opinion, which did not reflect the applicable Brazilian law because it relied on a novel theory regarding potential non-exempt borrowers and because an examination of Brazilian law confirmed that the Central Bank was immune from tax. The D.C. Circuit, however, held that the Minister of Finance's order to pay the tax was entitled to deference under the act of state doctrine, and remanded for a determination of whether the Brazilian taxes were actually paid by the Central Bank and whether Riggs' foreign tax credits must be reduced by the amount of the subsidy represented by the Brazilian pecuniary benefit program.

In addition to the "Central Bank Restructured Debt" issue in Riggs, the case also involved the disallowance of claimed foreign tax credits attributable to Riggs' net loans to non-tax-immune borrowers in Brazil. The Service argued that Riggs' credits should be disallowed in full on the basis that Riggs had no enforceable legal liability for the Brazilian withholding tax on the interest from such loans (the "Legal Liability" issue); and in the alternative, the credits should be disallowed in part by the application of the indirect subsidy regulations to the pecuniary benefit (the "Subsidy" issue). Consistent with past cases, the Tax Court held for Riggs on the "Legal Liability" issue, and for the Service on the "Subsidy" issue. See Nissho Iwai Am. Corp. v. Commissioner, 89 T.C. 765 (1987); Norwest Corp. v. Commissioner T.C. Memo. 1992-282, affd. 69 F.3d 1404 (8th Cir. 1995), cert. denied 517 U.S. 1203 (1996); Continental Illinois Corp. v. Commissioner, T.C. Memo. 1988-318, affd. without published opinion sub nom. Citizens & Southern Corp. & Subs. v. Commissioner, 919 F.2d 1492 (11th Cir. 1990), aff'd in part and rev'd in part 998 F.2d 513 (7th Cir. 1993), cert. denied 510 U.S. 1041 (1994). See also Bankers Trust New York Corp. v. United States, 36 Fed. Cl. 30 (1996), appeal docketed Fed. Cir. April 2, 1999 ("Subsidy" issue only; given the rulings in favor of the Service in the 7th and 8th Circuits, "to hold differently in this case would be to undermine the uniform application of the tax system among the citizenry"). In Riggs, neither party appealed these two issues.

In pursuing the resolution of cases at the administrative level with respect to net loans to tax-immune entities, such as the net loans giving rise to the “Central Bank Restructured Debt” issue described above, we recommend that the Service continue to pursue the disallowance of the full amount of foreign tax credits claimed based on the noncompulsory and payment issues, and in part based on the subsidy issue, framed in the Riggs litigation. In addition, credits should be disallowed with respect to net loan interest payments on deposit at the Central Bank under Resolution 432. See Riggs National Corp. v. Commissioner, 107 T.C. 301, 310 (1996).

With respect to loans other than tax-immune debt (i.e. loans other than net loans to governmental entities such as the Central Bank), we recommend that the Service concede the “Legal Liability” issue and require that taxpayers concede the “Subsidy” issue. This recommendation is consistent with the outcome of the litigation of these issues in every court to date. To our knowledge, the “Subsidy” issue does not extend beyond June 1985, at which time Brazil reduced the subsidy to zero.

Finally, any foreign tax credits claimed with respect to Brazil should be verified through receipts (“DARFs”) and not “borrower letters.” See Continental Illinois Corp. v. Commissioner, 998 F.2d 513, 517 (7th Cir. 1993), cert. denied 510 U.S. 1041 (1994); Norwest Corp. v. Commissioner T.C. Memo. 1995-453, 70 T.C.M. (CCH) 779, 781-83.

If you have any questions, please call (202) 622-3850.

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