Nissho Iwai American Corp. v. Commissioner, 89 T. C. 765 (1987)

Foreign tax credits are reduced by subsidies received by the foreign borrower, except where a grandfather clause applies.

Summary

Nissho Iwai American Corp. (NIAC) lent money to a Brazilian corporation, Nibrasco, which paid interest net of Brazilian withholding tax. Brazil provided Nibrasco a subsidy based on the tax paid. The Tax Court held that NIAC was legally liable for the tax but that the credit was reduced by the subsidy, except for interest accrued before January 1, 1980, due to a grandfather clause in Rev. Rul. 78-258. The court also denied NIAC's claim for a foreign tax credit on interest from funds deposited under Brazilian Resolution No. 432 due to insufficient proof of tax withholding.

Facts

NIAC, a U. S. subsidiary of a Japanese corporation, lent $20 million to Nibrasco, a Brazilian corporation, in 1978. The loan was structured as a net loan, with Nibrasco agreeing to pay interest free of Brazilian withholding tax. Brazil imposed a 25% withholding tax on interest paid to foreign lenders, but also provided Nibrasco a subsidy ranging from 40% to 95% of the tax paid. NIAC claimed foreign tax credits for the full amount of the Brazilian withholding tax. Additionally, Nibrasco deposited funds with the Central Bank of Brazil under Resolution No. 432, and NIAC sought a credit for taxes on interest from these deposits.

Procedural History

The Commissioner of Internal Revenue initially disallowed 85% of NIAC's claimed foreign tax credits, later increasing the disallowance to 95% for certain periods and ultimately disallowing the entire credit. NIAC challenged these adjustments in the U. S. Tax Court, which ruled on the legal liability for the Brazilian tax, the impact of the subsidy on the foreign tax credit, and the credit claim regarding Resolution No. 432 deposits.

Issue(s)

1. Whether NIAC was legally liable for the Brazilian withholding tax paid by Nibrasco?
2. Whether the Brazilian subsidy received by Nibrasco reduced the amount of foreign tax credit allowable to NIAC under section 901?
3. Whether NIAC was entitled to a foreign tax credit for withholding taxes on interest received from funds deposited by Nibrasco with the Central Bank of Brazil pursuant to Resolution No. 432?

Holding

1. Yes, because under Brazilian law, NIAC was legally liable for the withholding tax despite Nibrasco's obligation to pay it.
2. Yes, because the subsidy received by Nibrasco reduced the amount of the foreign tax credit, except for interest accrued before January 1, 1980, due to the grandfather clause in Rev. Rul. 78-258.
3. No, because NIAC failed to provide sufficient proof of tax withholding by the Central Bank on the interest from the Resolution No. 432 deposits.

Court's Reasoning

The court determined that the Brazilian withholding tax was imposed on the foreign lender (NIAC), with Nibrasco merely required to pay it on NIAC's behalf. The court upheld the validity of temporary regulations under section 901, which stated that foreign tax credits should be reduced by any subsidies received by the borrower or related parties. However, the court recognized the grandfather clause in Rev. Rul. 78-258, which allowed NIAC full credit for taxes on interest accrued before January 1, 1980. Regarding the Resolution No. 432 deposits, the court found NIAC failed to carry its burden of proof to show any tax was withheld by the Central Bank.

Practical Implications

This decision clarifies that U. S. taxpayers must account for foreign subsidies when claiming foreign tax credits, except where specific grandfather clauses apply. It emphasizes the importance of understanding the interaction between foreign tax laws and U. S. tax regulations when structuring international loans. The ruling also highlights the need for thorough documentation and proof when claiming foreign tax credits, particularly for unique financial arrangements like those under Resolution No. 432. Subsequent cases and regulations have further codified the principle that subsidies reduce foreign tax credits, impacting how multinational corporations manage their tax liabilities.