

Tax Court Finds Guaranty Payment Not Subject to U.S. Withholding

On February 17, 2010, the United States Tax Court ruled that guaranty fees paid by a U.S. subsidiary to its parent foreign corporation were not subject to U.S. withholding tax.

The case, *Container Corp. v. Commissioner*, dealt with a Mexican corporation that had charged its U.S. subsidiary \$6.6 million in guaranty fees over several years to guarantee the U.S. subsidiary's debts. Under prior case law, including in particular the U.S. Court of Claims decision in *Bank of America v. U.S.*, letter of credit fees were held to be sourced in the same manner as payments of interest, namely, based on the country of residence of the debtor. Practitioners generally believed, and it has been the position of the Internal Revenue Service ("IRS") in published guidance issued in 2001, that guaranty fees should be treated in the same manner. Due to this uncertainty many foreign parent corporations that have guaranteed debt of their U.S. subsidiaries have been reluctant to charge guaranty fees unless an applicable income tax treaty provision eliminated the U.S. withholding tax risk, especially where the U.S. subsidiary was in a loss position.

In *Container Corp.*, the IRS argued that the guaranty fees should be sourced like interest and thus, subject to a 30% U.S. withholding tax. However, the Tax Court found that the guaranty fees were analogous to payments for services rendered. The court distinguished a letter of credit from a guaranty by noting that the person extending a letter of credit has a primary legal obligation to pay the debt, while a person extending a guaranty has only a secondary obligation. In addition, the court analogized a letter of credit to a short-term loan, while finding that the guarantor was providing a service. As such, the Tax Court found that the guaranty did not have the characteristics of a loan, thereby precluding a sourcing of the guaranty payments under the interest sourcing rules.

Income from services is sourced where the services are performed. Because the guaranty was provided by a Mexican corporation with operations in Mexico, the fees were held by the Tax Court to constitute Mexican-source income. Accordingly, the guaranty fees paid to the Mexican parent corporation by its U.S. subsidiary were found not to be subject to U.S. withholding tax.

Given the published guidance to the contrary, it will be interesting to see if the IRS appeals this decision. The IRS has not yet made any official announcements regarding the decision.

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Chicago Office
+1.312.583.2300

Los Angeles Office
+1.310.788.1000

Shanghai Office
+86.21.2208.3600

Frankfurt Office
+49.69.25494.0

Washington, DC Office
+1.202.682.3500

New York Office
+1.212.836.8000

London Office
+44.20.7105.0500

West Palm Beach Office
+1.561.802.3230