

March 2010

## Tax Law

### Alert

# U.S. Subsidiary's Guaranty Payments to Foreign Parent are Not U.S.-Sourced Income Subject to Withholding Tax

BY SEAN M. KING AND MATTHEW C. MARSHALL

In *Container Corp. v. Commissioner*, the United States Tax Court examined the source of fees that a U.S. subsidiary corporation paid to its foreign parent corporation in return for the foreign parent's guarantee of the U.S. subsidiary's debts.

#### Facts

A U.S. subsidiary ("US-Sub") of a Mexican parent corporation ("MX-Parent") paid fees to MX-Parent in return for MX-Parent's guarantee of US-Sub's debt obligations. US-Sub paid MX-Parent guarantee fees equal to 1.5 percent of the debt's outstanding principal balance per year (the "Guarantee Fees"). US-Sub did not withhold tax from the Guarantee Fees. The IRS issued a notice of deficiency to US-Sub after it determined that US-Sub should have withheld tax on the Guarantee Fees.

#### Income Sourcing and Withholding Tax

Under income-sourcing rules, the source of interest income is determined by reference to the obligor's place of residence. A foreign lender that receives interest from a U.S. obligor has U.S.-sourced interest income, and the United States imposes a 30 percent tax on a foreign corporation's U.S.-sourced interest income. The United States, therefore, would require the U.S. obligor to, (i) withhold the 30 percent tax from the interest payment to the foreign lender and (ii) remit the tax to the IRS. The U.S. obligor, in turn, would be liable for the 30 percent tax if it failed to withhold and remit the tax.

The source of income from the provision of services is determined by reference to the service provider's location. In the case at hand, a Mexican company that provides services to a U.S. customer from its office in Mexico would generally have Mexican-sourced income, and the United States should not tax services that the Mexican company renders outside of the United States. It is also important to note that the United States does not require U.S. customers of foreign-sourced services to withhold tax when they pay for the foreign-sourced services.

#### The Parties' Positions

In *Container Corp.*, the IRS argued that the Guarantee Fees were analogous to interest. The IRS further argued that the Guarantee Fees were U.S.-sourced income because US-Sub was the obligor. The IRS argued that US-Sub was liable for withholding the 30 percent tax on its payments to MX-Parent and remitting it to the IRS.

Conversely, US-Sub argued that MX-Parent was providing a service to US-Sub by guaranteeing its debts. US-Sub argued that the guarantee, as a service, had a Mexican source, and, as a result, US-Sub was not liable for withholding the 30 percent tax from the Guarantee Fees and remitting it to the IRS.

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Editorial inquiries should be directed to Farhad Aghdami at 804.783.6440 or aghdami@williamsmullen.com

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## The Tax Court's Analysis and Ruling

The Tax Court held that MX-Parent's guarantee lacked the principal characteristics of a loan because MX-Parent did not extend money to US-Sub. The Tax Court also found that the Guarantee Fees compensated MX-Parent for incurring a contingent future obligation to pay US-Sub's debt obligations. US-Sub was paying MX-Parent for possible future action, not for a current loan of money.

The Court concluded that MX-Parent's guarantee was more analogous to a service. Since the source of services is the location of the service provider, the Guarantee Fees were not U.S.-sourced income. The Court ruled that US-Sub was not required to withhold and remit tax on the Guarantee Fees it paid to MX-Parent.

## Review of Income Sourcing

Williams Mullen recommends that its clients review their payments to foreign persons, including their intercompany payments to foreign affiliates. It is important to determine the payments' source under the income-sourcing rules and to assess compliances with withholding tax requirements. The firm advises numerous clients on the implications of income-sourcing rules and U.S. withholding taxes applicable to payments of interest, dividends, royalties, gains from the sale of real estate, and other income or gains from business activities.

If your company makes payments to foreign persons, and you are concerned about the income-sourcing rules and withholding tax requirements, please contact a member of the firm's Tax Law Practice Group.

*For more information about this topic and Williams Mullen's International Tax practice, please contact Sean M. King at [sking@williamsmullen.com](mailto:sking@williamsmullen.com) or 804.644.9812.*

## Williams Mullen Tax Law Team

### Farhad Aghdami

Chair, Tax Law Team  
804.783.6440  
[aghdami@williamsmullen.com](mailto:aghdami@williamsmullen.com)

### Jeffrey D. Chadwick

[jchadwick@williamsmullen.com](mailto:jchadwick@williamsmullen.com)

### Jenny L. Connors

[jconnors@williamsmullen.com](mailto:jconnors@williamsmullen.com)

### Thomas R. Frantz

[tfrantz@williamsmullen.com](mailto:tfrantz@williamsmullen.com)

### J. Conrad Garcia

[cgarcia@williamsmullen.com](mailto:cgarcia@williamsmullen.com)

### James Philip Head

[jhead@williamsmullen.com](mailto:jhead@williamsmullen.com)

### Sean M. King

[sking@williamsmullen.com](mailto:sking@williamsmullen.com)

### Montgomery Knight, Jr.

[mknight@williamsmullen.com](mailto:mknight@williamsmullen.com)

### Steven B. Long

[slong@williamsmullen.com](mailto:slong@williamsmullen.com)

### Matthew C. Marshall

[mmarshall@williamsmullen.com](mailto:mmarshall@williamsmullen.com)

### Charles B. Neely, Jr.

[cneely@williamsmullen.com](mailto:cneely@williamsmullen.com)

### Craig L. Rascoe

[crascoe@williamsmullen.com](mailto:crascoe@williamsmullen.com)

### Nancy S. Rendleman

[nrendleman@williamsmullen.com](mailto:nrendleman@williamsmullen.com)

### Charles L. Steel, IV

[csteel@williamsmullen.com](mailto:csteel@williamsmullen.com)

### Maria S. Stefanis

[mstefanis@williamsmullen.com](mailto:mstefanis@williamsmullen.com)

### John H. Turner

[jturner@williamsmullen.com](mailto:jturner@williamsmullen.com)

Please visit  
[www.williamsmullen.com](http://www.williamsmullen.com)  
for more information about  
the Williams Mullen Tax Law  
Team.



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