NEWS ANALYSIS

U.S. Issues Guidance on Apportionment of Charitable Contributions to U.S.-Source Income

by Milton Cerny and Rebecca Rosenberg

New temporary and proposed regulations issued on July 27, 2004, affect the apportionment of charitable deductions between U.S.- and foreign-source income. See temp. Treas. reg. section 1.861-8T(e)(12). These regulations are generally intended to be taxpayer-favorable and to encourage charitable giving.[1] They apply to both U.S. and foreign donors. The new regulations remove the former proposed regulations' foreign tax credit detriment for taxpayers who make charitable donations earmarked for foreign charitable activities. Instead, the temporary regulations create an actual foreign tax credit benefit for charitable giving. Under the new temporary and proposed regulations, a taxpayer who makes a section 170 charitable contribution can use more foreign tax credits than an identical taxpayer who does not contribute, even though the credits relate to foreign taxes that presumably lack any relationship to the charitable contribution.

The new apportionment rule is based more on the policies of encouraging charitable giving and reducing administrative burdens than on any technical argument for apportioning charitable deductions to U.S.-source income. In fact, the preambles to the temporary and proposed regulations do not proffer a technical argument for the change. The previous final regulations' approach of apportioning charitable deductions pro rata, as expenses not definitely related to any class of income, was a good practical solution, but the policy of encouraging charitable donations favors the new regulatory rules.

The regulations' preambles focus on the effect of the new apportionment rules on donors' foreign tax credit calculations. However, the regulations may also affect the U.S. tax of foreign donors by changing the allocation of charitable deductions to effectively connected income.

I. Application of the New Regulations to Different Types of Charitable Donors

A. U.S. Corporations and U.S. Citizens or Resident Individuals

Under rules not amended by the regulations, Internal Revenue Code section 170 and some treaties allow a deduction for charitable contributions. For U.S. taxpayers, the new regulations should not affect the amount of the allowable deduction.

Under the new temporary and proposed regulations, a section 170 deduction is apportioned against U.S.-source income, increasing the ability to use foreign tax credits (if the taxpayer has creditable foreign taxes).

Under the new proposed regulations, charitable deductions that are allowed under a treaty but not under section 170 are proposed to be apportioned against foreign-source income from the other treaty country (which would make it more difficult to use foreign tax credits).

B. Foreign Corporations and Nonresident Alien Individuals

Under rules not amended by the regulations, charitable deductions are allowed under section 170 via cross-reference from section 873(b)(2) (for individuals) or 882(c)(1)(B) (for corporations), or may be allowed under some tax treaties. The regulations are likely to affect how much of the deduction is apportioned against ECI. Therefore, the amount of these deductions, which actually reduce U.S. tax, may well be affected by the new regulations, depending on the taxpayer's facts.

Under the new temporary and proposed regulations, charitable deductions allowed under section 170, 873(b)(2), or 882(c)(1)(B) are apportioned against U.S.-source income.

- This is likely to reduce ECI, reducing U.S. tax, although the precise result will vary depending on the relative amounts of the taxpayer's U.S.-source income that are ECI and other income.
- This will reduce U.S.-source income for purposes of the foreign tax credit allowed to foreign corporations and foreign nonresident individuals under section 906, but that credit is not likely to be significant for most taxpayers.

Charitable deductions allowed under a treaty but not under section 170, 873(b)(2), or 882(c)(1)(B) are proposed to be apportioned against foreign-source income from the other treaty country. This is likely to increase U.S. tax by decreasing the deductions

[1] *See* T.D. 9143 ("The revision is intended to ensure that the taxpayer is not discouraged from making a charitable contribution that is deductible under section 170 simply because the allocation and apportionment rules would reduce the taxpayer's foreign-source income and, accordingly, the taxpayer's foreign tax credit limitation as a result of the deduction.") (For T.D. 9143, *see 2004 WTD 145-20* or *Doc 2004-15400*.)

apportioned to ECI, although the results will depend on the taxpayer's facts.

II. Discussion of the New Regulations

A. Apportionment of Section 170 Charitable Deductions to U.S.-Source Income

The regulations address two different fact patterns. First, the temporary and proposed regulations address the apportionment of charitable deductions allowed under section 170, including deductions allowed (by cross-reference) to nonresident alien individuals under section 873(b)(2) and to nonresident foreign corporations under section 882(c)(1)(B). The new regulations state that:

> The deduction for charitable contributions that is allowed under sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(i) shall be apportioned between the statutory grouping (or among the statutory groupings) on the basis of the relative amounts of gross income *from sources in the United States* in each grouping. (Emphasis added.)

The effect of this language is to apportion charitable deductions against U.S.-source income. For example, for purposes of the foreign tax credit limitation fraction, the charitable deduction would reduce U.S.-source rather than foreign-source income, which would increase the foreign tax credit limitation fraction under section 904(a)[2] and thus maximize the taxpayer's use of foreign tax credits.[3]

The new rule for section 170 deductions also applies to a foreign corporation's or nonresident foreign individual's apportionment of deductions between ECI regarding the conduct of a trade or business in the United States and other income. See Treas. reg. section 1.861-8(f). Allocating charitable deductions between ECI and other income based on the relative amounts of U.S.-source income in each category can be expected to result in larger apportionments to ECI (compared to other categories and compared to the results under prior law), reducing ECI and thus reducing U.S. tax.

Although foreign-source ECI is possible, it tends to occur much less frequently than U.S.-source ECI. The effect of the new rule on any particular foreign corporation depends on the amount of a foreign corporation's U.S.-source income that is ECI compared to the amount of the corporation's U.S.-source income that is not ECI (for example, interest and dividends).[4] If most of the foreign corporation's U.S.-source income is ECI, its U.S. tax should be reduced by the new apportionment of charitable deductions (in contrast to the old rule, which would have apportioned the charitable deductions ratably between ECI and non-ECI). If most of the foreign corporation's U.S.-source income is not ECI and is instead subject to gross-basis U.S. withholding tax, the corporation is likely to be disadvantaged by the new apportionment rule. Although results will vary based on each foreign corporation's particular fact pattern, we expect that the apportionment of charitable deductions to U.S.-source income will often reduce U.S. tax by reducing ECI.

Thus, for foreign corporations and nonresident aliens, the new regulations are likely to change the amount of the charitable deduction that can be used to reduce U.S. tax (because those taxpayers can only use deductions that are apportioned to ECI). In contrast, for U.S. taxpayers, the new regulations do not change the amount of the section 170 deduction, but do give taxpayers a more beneficial foreign tax credit limitation fraction (because the apportionment of charitable deductions affects the foreign tax credit, but not the actual allowance of the deduction, for U.S. persons).

The regulations' apportionment of charitable deductions based on U.S.-source income will also reduce U.S.-source income for purposes of the foreign tax credit allowed under section 906 to nonresi-

[2]Section 904(a) limits the foreign tax credit to the lesser of (1) foreign taxes paid or accrued, or (2) the product of the taxpayer's U.S. tax times the fraction of foreign-source taxable income over worldwide taxable income (the foreign tax credit limitation fraction or foreign tax credit limitation). Thus, it is almost always to the taxpayers' benefit to increase foreign-source income and decrease U.S.-source income to increase the value of the fraction and maximize the ability to use foreign tax credits. Allocating charitable deductions to U.S.-source income reduces the denominator (worldwide taxable income), increasing the fraction and enabling taxpayers to use more foreign tax credits (if they have paid or accrued creditable foreign taxes).

[3]Thus, the preamble states that "[f]or example, where a deduction for charitable contributions is allocated and apportioned for purposes of the foreign tax credit limitation, the charitable contribution deduction is allocated to all of the taxpayer's gross income and apportioned solely to the residual grouping consisting of U.S.-source gross income." T.D. 9143.

[4]Foreign corporations and nonresident foreign individuals are generally subject to U.S. tax 1) on a net basis on effectively connected income, and 2) on a gross basis on U.S.-source "fixed, determinable, annual, and periodical income," which generally includes rents, royalties, dividends, and interest. *See* sections 871, 881, 882. Therefore, allocation of charitable deductions to ECI reduces U.S. tax, while allocation to non-ECI (that is, to income not subject to *net* U.S. tax, as opposed to gross-basis tax before deductions) generally does not reduce U.S. tax.

dent aliens and foreign corporations. However, that credit is so narrow that the benefits are not likely to be significant for most foreign taxpayers. The section 906 foreign tax credit is available only for foreign taxes imposed on income effectively connected with a U.S. trade or business, not including taxes imposed on U.S.-source income that would not be imposed but for the taxpayer's residence (or a similar concept) in the foreign country.

The new temporary regulations apply to contributions made on or after July 28, 2004, but taxpayers can elect to apply the new rules to contributions made in tax years ending on or after July 28, 2004, even if the contributions were made before July 28, 2004. The new regulations expire by July 27, 2007.

B. Apportionment of Treaty-Allowed Deductions to Foreign-Source Income

New proposed (not temporary) regulations apply a different rule to charitable contributions that are allowed only under a tax treaty and not under section 170, 873(b)(2), or 882(c)(1)(B).[5] The proposed regulations would apportion such deductions between and among statutory groupings based on the pro rata amounts of foreign-source income from the treaty country in each statutory grouping. See prop. Treas. reg. section 1.861-8(e)(12)(iii). In other words, the charitable deductions allowable only by reason of a treaty will be apportioned against foreign-source income from the other country participating in the treaty. This should have the effect of reducing foreign tax credits by reducing the numerator of the foreign tax credit limitation fraction. The new rule on apportionment should not affect the amount of a U.S. taxpayer's charitable deduction.

For foreign corporations and nonresident foreign individuals, the proposed rule will probably have the effect of reducing non-ECI and not permitting the deduction to reduce U.S. tax. The effects will vary depending on how much of the taxpayer's foreign-source income from the treaty country is ECI versus non-ECI.

This proposed rule should apply mostly to donations to foreign charities, because it is limited to deductions not allowed under section 170. The regulations are proposed to be prospective only, and apply to charitable contributions made on or after the date on which the regulations are finalized and published in the *Federal Register*.

III. Prior Law

The preexisting (until July 28, 2004) final regulations provided that charitable deductions were apportioned ratably among statutory groupings (including U.S.- and foreign-source income). See former Treas. reg. sections 1.861-8(e)(9)(iv), 1.861-8T(c)(3).[6] Charitable deductions were treated as deductions not definitely related to any gross income. Treas. reg. section 1.861-8(e)(9). In contrast, the new regulations treat such deductions as definitely related and allocable to all of the taxpayer's gross income. Temp. Treas. reg. section 1.861-8T(e)(12); see also Treas. reg. section 1.861-8(b)(5). Practically speaking, the change to the allocation rule should not make much difference, because the meaningful change is the shift to apportionment based on U.S.-source income in each category.

Proposed regulations issued in 1991 would have apportioned charitable deductions to foreign-source income if the taxpayer knew or had reason to know that the contribution would be used only outside the United States, and to U.S.-source income if the taxpayer both designated the contribution for use solely within the United States and reasonably believed that it would be used solely within the United States. See prop. Treas. reg. section 1.861-8(e)(12). If neither of these rules applied, the proposed regulations would have apportioned the deduction ratably. Commentators argued that the regulations would discourage donations for foreign charitable activities and would create administrative burdens. The IRS has withdrawn those proposed regulations.

IV. Summary

The regulations' apportionment of deductions to U.S.-source income improves a charitable donor's ability to use foreign tax credits (so that a person making a charitable contribution could claim more foreign tax credits than an identical person who did not contribute, due to the section 904(a) foreign tax

[5]For example, the current U.S. tax treaty with Canada allows such a deduction. *See* Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital (entered into force August 16, 1984), Art. XXI (5).

[6]The regulations that previously applied to charitable deductions (Treas. reg. section 1.861-8(e)(9)) contained a cross-reference to Treas. reg. section 1.861-8(c)(2). That section, in turn, refers to Treas. reg. section 1.861-8T(c)(2), which describes ratable apportionment based on the assets that generate income within each statutory group. However, section -8(e)(9) was apparently intended to cross-reference to the rules on apportionment based on relative amounts of gross income, as described in paragraph (c)(3). The reference to paragraph (c)(2) appears to have been an oversight, caused by a renumbering of paragraph (c)(2) as (c)(3) without correction of the cross-reference in paragraph (e)(9). *See* T.D. 7456, 1977-1 C.B. 200, 204, 211 (showing the original cross-reference). The new temporary and proposed regulations correct the cross-reference in paragraph (e)(9).

credit limitation). For foreign corporations and nonresident foreign individuals, apportionment to U.S.-source income is likely to reduce U.S. tax (by reducing ECI) more than would have occurred under the previous final regulations.

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German Court Clarifies Taxation of Interposing EU Companies

by Christian Ehlermann and Katja Nakhai

In a recently published decision, the German Federal Tax Court (BFH) has ruled that a German company's shareholding in an international financial service center (IFSC) corporation in Dublin should receive the same treatment as a domestic holding for purposes of the German antiabuse rules.

The BFH's February 25 decision made some significant general statements about the implications of interposing companies located in other EU member states for purposes of the German antiabuse rules.

In previous cases involving only German companies, the BFH held that the interposition of a domestic corporation that is "not merely temporary" should not be considered abusive under German substance-over-form rules, regardless of the taxpayer's motives. When determining what constitutes an interposition that is "not merely temporary," the BFH looks at whether, on acquisition, the taxpayer intends to hold the participation for an extended period of time. If a foreign company was interposed, the BFH required a business purpose before it would accept the structure.

It now appears the BFH is adopting a different approach in light of the nondiscrimination principle in the EC Treaty, and the way that principle has been interpreted in recent decisions by the European Court of Justice. Considering the nondiscrimination principle and the fact that the interposition of a German entity would not be considered abusive, the BFH held that the interposition of an EU corporation should be treated in a manner similar to the interposition of a domestic corporation; therefore, the taxpayer's motives should not be questioned.

Moreover, the primary motive of the taxpayer to benefit from a lower corporate income tax rate in another jurisdiction should not be decisive, particularly as (at least in the case at issue) the tax advantages granted to IFSC companies are in line with EU state aid rules.

The BFH concluded that the interposition of an EU corporation should not be considered abusive if:

- the company has been interposed for a certain period of time (for example, two years in this case);
- the taxpayer had no intention of disposing of the participation on acquisition;
- the acquisition was not simply related to a specific business transaction; and
- the company had a minimum number of personnel and other resources to guarantee its ability to manage its business.

The court's decision is a positive development for taxpayers, as it increases the level of security for tax structuring in the European Union. Before the judgment, taxpayers always had to keep in mind that they needed to demonstrate business reasons for the interposition of a foreign company, even if the company was located in an EU member state. It appears they now merely have to demonstrate that the interposition of an EU corporation is not just temporary; the business reasons for the interposition should no longer be questioned. Therefore, it should be easier for taxpayers to estimate the level of risk associated with the interposition of such companies. The decision could also have implications for other German antiabuse provisions that treat foreign (and thus, EU) companies less favorably than domestic companies, such as the anti-treaty-shopping provisions in the German Income Tax Act or the CFC legislation.

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New Zealand to Amend Tax Rules to Foreign Trusts

by Adrian J. Sawyer

To ensure that New Zealand can meet its international commitments to full disclosure with other tax jurisdictions, the Tax Administration Act 1994 will be amended to impose new requirements on foreign trusts set up in New Zealand, according to a July 27 press release from Revenue Minister