Chief Counsel Memo on ADR payments highlights importance of income characterization under treaties

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In brief

The IRS Office of Chief Counsel on July 12 published a memorandum, AM 2013-003 (the 2013 memorandum), that addresses the characterization of payments made by a domestic depositary institution on behalf of a foreign corporation in consideration for a grant of the exclusive right to offer American Depositary Receipts (ADRs), and how such payments should be treated under US income tax treaties. While the memorandum does not have precedential value, it is an indication of IRS thinking on this issue.

In detail

Background

ADRs are used by non-US corporations to make their stock more accessible to US investors. In a typical ADR program, the foreign issuer will place its stock with a US financial institution that acts as a depositary institution with respect to the stock. The depositary institution then offers interests in the issuer's stock in the form of ADRs to investors in the US market.

The foreign issuer may enter into an agreement with a US financial institution providing that the financial institution will be the foreign issuer's exclusive depositary institution with respect to the ADR program for a period of time (known as a sponsored ADR program).

In consideration of such an exclusivity agreement, the depositary institution may agree to reimburse the foreign issuer for some of its expenses associated with the ADR program. The 2013 memorandum addresses the treatment of such payments made by a depositary institution to the foreign issuer. It concludes that such payments are compensation to the foreign corporation for its transfer of a property interest in the United States, are sourced within the United States and accordingly subject to 30% withholding under Section 1442 unless reduced by an income tax treaty, and are treated as "other income" — not royalties or business profits — under both the US and Organisation for Economic Co-Operation and Development (OECD) model income tax treaties.

This conclusion's impact can lead to disparate results for taxpayers because, while some treaties give exclusive taxing jurisdiction over "other income" to the state of residence, other treaties allocate primary taxing jurisdiction to the source state.

The US tax treatment of such payments previously was addressed by the IRS Office of Chief Counsel in a memorandum (AM 2010-006) issued in 2010 (the 2010 memorandum). The 2010 memorandum determined that ADR payments similar to those

at issue in the 2013 memorandum constituted income to the ADR issuer and should be characterized as US source income subject to the 30% tax under Section 882. However, the 2010 memorandum did not address how such payments should be characterized for income tax treaty purposes.

What types of payments does the 2013 memorandum address?

Both a foreign issuer and a US depositary institution incur expenses when instituting an ADR program.

A depositary institution may incur expenses with third parties for issuing the ADRs, including listing and SEC fees, legal and accounting fees, marketing fees, and proxy and reporting fees. The depositary institution generally passes these fees on to the investors in the ADRs in the form of investor fees. A depositary institution generally receives compensation from investors by charging the investors for various services in administering the ADR program in the form of issuing fees, dividend fees, and cancellation fees.

A foreign issuer may incur expenses such as legal fees, accounting fees, SEC registration costs, marketing expenses, expenses for participating in investor conventions, costs for acquiring and maintaining electronic communications systems, exchange and listing fees, filing fees, underwriting fees, mailing and printing costs in connection with sending out financial reports, annual reports and proxy mailings, and other administrative costs.

According to the 2013 memorandum, a depositary institution may offer to pay some of these issuer fees as an inducement for the issuer to grant the depositary institution an exclusive right to issue ADRs in the United States. Typically, the expenses the depositary institution agrees to pay are subject to a cap, and only expenses the issuer would not have incurred but for the ADR program are paid by the depositary institution. Payment may be through reimbursement of the issuer's expenses by the depositary, or the depositary may make payments on behalf of the issuer directly to third parties.

Observations

It is important to the legal conclusions in the 2013 memorandum that the expenses paid by the depositary institution are properly regarded as issuer expenses. The memorandum states that the expenses are issuer expenses but does not explain the rationale for this conclusion.

However, if the expenses in question are expenses that, in the absence of an agreement by the depositary institution to pay them, would be borne by the issuer (for example, if the issuer generally pays such expenses itself when instituting a non-sponsored ADR program), one might argue that such expenses are properly characterized as issuer expenses. Because both the issuer and the depositary institution benefit from the ADR program, the arrangement could be viewed as equivalent to a cost-sharing arrangement.

Although the 2013 memorandum reached the same conclusion as the 2010 memorandum, the analyses are different. The 2010 memorandum did not mention *Sabatini* (discussed below), stating only that the rights obtained from the issuer under a sponsored ADR program are similar to a franchise arrangement for the distribution of a product within a given marketplace, and that the ADR payments, due to their similarity to intangible property listed in Section 861(a)(4), should fall within the meaning of "other like property" for purposes of Section 861(a)(4).

Characterization of the payments under US federal income tax law

Section 881 imposes a 30% tax (collected by withholding under Section 1442) on the gross amount of any US-source fixed or determinable, annual or periodic (FDAP) income derived by a foreign corporation that is not effectively connected with a US trade or business.

Because, according to the 2013 memorandum, the payments were not effectively connected with a US trade or business, the crucial issue for purposes of determining whether they are subject to the 30% tax is whether the payments constitute US- or foreign-source income. That is, if the payments were foreign-source income, they generally would not be subject to tax in the hands of a foreign recipient, but if they were US-source income, they would be subject to the tax (subject to reduction or elimination under an applicable income tax treaty).

While the 2013 memorandum clarifies that the analysis of the character of particular ADR program payments will depend on all the relevant facts and circumstances, the 2013 memorandum characterizes the payments in question as follows:

> The ADR Program payments… represent consideration for the transfer from the Issuer to the [depositary institution] of exclusive rights to institute a sponsored program covering the Issuer's stock. The ADR Program payments are an inducement for the Issuer to enter into a sponsored ADR program with the [depositary institution]. Specifically, the [depositary institution] agrees to pay the Issuer's ADR Program expenses

> to obtain the exclusive right to be the sole distributor of ADRs with respect to stock in the Issuer. The payments therefore are consideration for the assurance of exclusive distribution rights… These exclusive ADR program rights constitute an interest in property in the United States for purposes of the taxation of foreign persons conveying those rights.

In analyzing the payments, the IRS discussed *Sabatini v. Commissioner*, 98 F.2d 753 (2d Cir. 1938), a case in which an author entered into contracts with a US publisher under which he granted the publisher the right to publish certain books. Some of these books were not subject to copyrights; however, the court held that payments received by the author from his contracts covering the publication of works that could not be copyrighted nevertheless constituted payments for the use of similar property. The court stated that the payments were made to the author for foregoing his right to authorize others to publish the works in the United States, and the rights the author granted were an interest in property in the United States.

Under Section 861(a)(4), income from US sources includes rentals and royalties from property located in the United States or from any interest in such property. The 2013 memorandum concludes that the ADR issuer, like the taxpayer in *Sabatini*, is foregoing its right to authorize another to perform certain activities in the United States, so the payments to the issuer represent compensation to the foreign issuer for its transfer of an interest in property in the United States.

Characterization of the payments for tax treaty purposes

US-source FDAP income payments subject to the 30% tax under Section 882 may be eligible for a reduction or elimination of the tax if the payment recipient is a resident of a country with which the United States has entered into an income tax treaty and if the recipient satisfies the treaty's eligibility for benefits requirements. Whether an item of income is eligible for a reduction or elimination of the 30% tax depends on the particular treaty in question and on whether the item of income satisfies the requirements applicable to the type of income under the treaty.

Most income tax treaties to which the United States is a party, for example, provide that royalties are eligible for either a reduction or an elimination of source-country taxation. In addition, income tax treaties often provide for the elimination of source-country taxation for "business profits" that are not attributable to a permanent establishment of the recipient in the income's source state. Finally, income tax treaties generally include a residual "other income" article that addresses the treatment of income not addressed in the applicable treaty's other articles.

The 2013 memorandum first analyzes whether the ADR payments are royalties for treaty purposes and concludes that the payments in question are not royalties as such term is defined in the US Model Income Tax Convention of 2006 (US Model) or the OECD Model Tax Convention on Income and Capital (OECD Model). The OECD Model (the US Model is nearly identical in this respect) defines royalties as "payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience."

The 2013 memorandum concludes that the treaty definition of "royalties" is restricted to payments for intellectual property and thus covers a narrower range of transactions than those covered by Section 861(a)(4), which covers payments from any interest in property located in the United States.

Next, the 2013 memorandum analyzes whether the payments constitute business profits for treaty purposes. It concludes that, while neither "business" nor "profits" is fully defined in the model treaties, the ADR program payments do not arise out of or support the conduct of the issuer's business; accordingly, the payments are not business profits within the meaning of the US and OECD Models.

Given that the ADR program payments are not properly classified as royalties or business profits under the Models (and do not fit within the definition of any other categories of income), the 2013 memorandum concludes that the payments are "other income" under both the US and OECD Models.

Observations

While the memorandum addresses only the US and OECD Models, rather than any treaties to which the United States is a party, the result likely would be the same under most US treaties currently in force. While the definition of royalties varies in many treaties, many of them define royalties similarly to the Models, i.e., potentially more narrowly than Section 861(a)(4). In addition, when payments are not effectively connected with the conduct of a US trade or business (as the 2013 memorandum assumes), it is unlikely that they would be considered business profits under a treaty.

The result of the characterization as other income will vary depending on the treaty in question. While both the

US and OECD Models contain other income articles that generally permit only the residence state to tax the income (so that on the facts presented, the 30% tax could be eliminated), this treatment is not universal under US income tax treaties. Indeed, some treaties, such as US treaties with China and Canada, give the nonresidence state the right to tax income arising in such state, so that the full 30% tax could apply.

In addition, if the income had been characterized as royalties, whether the 30% tax would be reduced or eliminated would depend on the treaty's specific provisions. Taxpayers resident in some treaty countries may benefit from the characterization of the payments as other income — because the relief from US taxation provided to other income is greater than that provided to royalties under the relevant treaty) — while other taxpayers may prefer the payments to be characterized as royalties because the applicable treaty provides greater benefits to royalties than to other income.

The takeaway

The IRS's conclusion in the 2013 memorandum with respect to the application of tax under Section 882 does not come as a surprise, because it is consistent with the 2010 memorandum's conclusion. With respect to how such payments should be characterized for treaty purposes, the 2013 memorandum illustrates that the treaty definition of royalties differs from the definition in the source rule under Section 861.

While the 2013 memorandum addresses a narrow class of payments, taxpayers in general should keep in mind that US federal income tax categorizations of types of income do not necessarily match up with treaty equivalents. The 2013 memorandum demonstrates the importance of the "other income" article in tax treaties. Because some treaties allocate primary taxing jurisdiction over "other income" to the source state, while other treaties allocate exclusive taxing jurisdiction to the residence state, the impact of income being characterized as other income may vary wildly, depending on the residence of the recipient.

Let's talk

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