

US

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Withholding on ADR fees

In a generic legal advice memorandum (GLAM), released at the end of last year, the IRS concluded that payments by a domestic depository institution (DI) to or on behalf of a foreign corporation for expenses of a sponsored American Depository Receipts (ADR) program are includible in the foreign corporation's gross income and are subject to US federal withholding tax.

ADR programs exist in both a sponsored and unsponsored form. The GLAM only addresses payments to corporations in sponsored programs. A sponsored ADR program is one in which the foreign corporation registers with the Securities and Exchange Commission and chooses an exclusive DI. ADR programs are designed to simplify the US trading of stock of foreign corporations.

Under such a program, the foreign corporation's stock is placed, maintained and controlled with a domestic financial institution that acts as a DI. The DI will subsequently offer interests in the corporation's stock in the form of ADRs to investors in the US market. ADRs are priced in US dollars and the DI makes dividend equivalent payments in US dollars to the investors based on dividends paid in foreign currency by the corporation to the DI.

US investors can also trade ADRs, similar to shares of domestic corporations, on US exchanges and over-the-counter markets. ADRs help to meet the needs of US investors who want to invest easily in foreign companies, without the inconveniences of cross-border or cross-currency transactions. Investors in sponsored ADRs (in contrast to unsponsored ADR programs) have rights similar to stockholders, including the right to receive reports, vote their shares, and receive dividends.

To institute an ADR program, the corporation incurs expenses and to induce a corporation to have an exclusive arrangement with a DI for a sponsored ADR program, it is common for a DI to pay a portion of the expenses the corporation will incur in setting up the program.

Referring to case law, the IRS argued that

the payment of expenses of a taxpayer by another is includible in the taxpayer's gross income and that the payments are includible regardless of whether they are made directly to the taxpayer or to a third party on the taxpayer's behalf.

The IRS referred to four factors in determining that the expenses paid by the DI are in fact those of the foreign corporation: (i) the payments are for expenses any corporation would expect to incur to sell its stock in the US; (ii) the DI does not have a pre-existing obligation to incur these and the source of its obligation being solely by virtue of its agreement with the corporation; (iii) the corporation has discretion over which accounting firm, law firm, and vendor to use in instituting its ADR program when it incurs the expenses; and (iv) the DI does not pay all of the expenses necessary to set up the ADR program, but only an agreed upon or capped amount, leaving the balance payable by the foreign corporation.

The IRS also noted that under the generic facts of the GLAM, the DI has not paid any direct consideration for the exclusive right to serve as the depository for the corporation's ADR program, thus suggesting that the DI's payments of the corporation's expenses are intended to compensate the corporation for its agreement to deal exclusively with the DI.

Finally, the DI's payments to, or on behalf of, the corporation are primarily and directly for the corporation's benefit in instituting the ADR program. They are not primarily for the DI's benefit. Therefore, the IRS concluded the payments by the DI to the corporation, or to third parties on behalf of the corporation, of the corporation's expenses incurred to institute an ADR program are gross income to the foreign corporation.

After determining that such payments are includible as gross income to the foreign corporation, the GLAM addresses whether the payments are subject to US federal withholding tax. The IRS reasoned that because the DI obtains, for a period of time, the right to profit from the distribution of shares of the corporation in the US market without competition from other DIs (which includes the right to benefit from the use of the corporation's trade name and reputation in marketing the ADRs), it has obtained an interest in intangible property with the result that the payments should be treated as royalties.

These royalties, according to the IRS, should be treated as US source because the

rights are used in the US. Since US source fixed or determinable annual or periodical income of a foreign corporation is subject to a 30% US federal withholding tax, the IRS concluded that the ADR program payments should be subject to the 30% withholding tax, unless the corporation is engaged in a trade or business in the US or that amount is otherwise reduced by a treaty.

A GLAM is informal advice on a tax issue given by the IRS National Office to the IRS field offices based on a generic set of facts. It is not taxpayer-specific advice. While it represents the IRS's position, it is not legal precedent.

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