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COMMONWEALTH of VIRGINIA

Department of Taxation
Richmond, Virginia 23282

MEMORANDUM

TO: William J. West, Supervisor
Technical Services Section
Office Services Division

DATE: November 28, 1984

SUBJECT: Investment in Euro Dollars
Foreign Source Income Subtraction

The term "Euro Dollars" was coined in the 1970's to refer to deposits in foreign branches of U.S. Banks. The deposits were in dollars but were not subject to U.S. restrictions on payment of interest on demand deposits. The term is now used loosely to refer to almost any foreign investment which is in dollars instead of a foreign currency.

Under I.R.C. Section 862 interest is from sources without the United States unless it is defined as being from sources within the United States under I.R.C. Section 861. The latter section defines the source of interest in terms of the residence of the debtor who pays the interest. There are a number of exceptions; among them is interest on deposits with a foreign branch of a domestic corporation engaged in the commercial banking business.

It appears that almost all interest paid by a foreign person, corporation or a foreign branch of a U.S. bank will be treated as from sources without the United States. Thus "Euro Dollar" interest appears to qualify for the Virginia subtraction for income from foreign sources.

The taxpayer is required to maintain the records necessary to prove that it is entitled to a foreign source income subtraction. Where the income in question has been treated as income from without the United States in the federal return most of the taxpayer's burden of proof has been satisfied. Where the income has been treated as domestic income in the federal return the auditor is entitled to presume that it is not foreign source income unless the taxpayer can convincingly prove otherwise.

When auditors are examining a subtraction for Euro Dollar interest, I suggest that they ask for I.R.S. Form 1118. If the income does not qualify as income from without the United States under federal law then it does not qualify for the foreign source income subtraction under Virginia law.

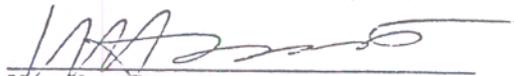
If the taxpayer claims that the income does qualify as income from without the United States under federal law but the taxpayer elected not to claim a foreign tax credit, then the auditor must investigate further to determine the nature and source of the income and the expenses attributable to the income. Treasury Regulations Sections 1.861-1 through 1.864-7 must be consulted. The procedure is set forth in Virginia Regulation Section 630-3-302.



Danny M. Payne, Director
Tax Policy Division

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Approved:



W. H. Forst
Tax Commissioner