INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

November 17, 2004

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-129392-04/CC:INTL:B1

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:

Date of Conference: October 7, 2004

LEGEND:

Taxpayer	=	
Parent Co	=	
Treaty	=	
Certificate	=	
Country A	=	
Country A Agency	=	
Country A Entity	=	
Country A Political Subdivision	=	
Country B	=	

Country B Entity	=
Country C	=
Country C Entity	=
Country D Entity	=
Country E Entity	=
Country F Entity	=
Country G	=
Country G Entity	=
Country H Entity	=
City	=
Customers	=
Market	=
Number I	=
Number J	=
Number K	=
Number L	=
Number M	=
Official N	=
Official O	=
Products	=
Region P	=
Region Q	=
State R	=
State R Entity	=
State R Law	=
State R Statute	=
State S	=
Taxpayer Advisor	=
Type T	=
Type U	=
Type V	=
w-percent	=
x-percent	=
y-percent	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=

Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=
Date 18	=
Date 19	=
Date 20	=
Date 21	=
Date 22	=
Date 23	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=
$ii	=
$jj	=
$kk	=
$ll	=
$mm	=
$nn	=
$oo	=
$pp	=
$qq	=
$rr	=
$ss	=
$tt	=

ISSUES:

1. To what extent is Taxpayer entitled to benefits as a resident of Country A under the Treaty?

2. If it is determined that Taxpayer is entitled to Treaty benefits as a resident of Country A with respect to certain interest income, may the Service deny credits for foreign taxes paid by Taxpayer on or with respect to such income?

CONCLUSIONS:

1. Taxpayer is not entitled to benefits under the Treaty for the following reasons:

a. Taxpayer's claim of Treaty benefits rests on an incorrect interpretation of Article to award taxing jurisdiction to Country A. Under the correct interpretation of Article , Taxpayer should be considered a resident of the United States for Treaty purposes.

b. Under the facts and circumstances of this case, Taxpayer effected an election to be treated as a domestic corporation, thus permitting the Service to invoke Article , the "saving clause," and tax Taxpayer as a domestic corporation as if the Treaty had not come into effect.

c. Taxpayer's claim of Treaty benefits is inconsistent with both Taxpayer's inclusion on Parent Co's consolidated federal income tax return and the purpose and intent of the Treaty and should therefore be disallowed under the general rules for application of the Treaty in Article .

d. To allow Taxpayer the claimed Treaty benefits would result in an abuse of the Treaty and the United States may therefore deny such benefits under Article of the Treaty.

Taxpayer may accordingly be denied any Treaty exclusion in its tax year ending Date 16, Year 9, with respect to the gain realized on the transfer of the IP to Country B Entity, the gain realized on the redemption of Country B Entity Type V stock, and interest income from certain promissory notes and an investment.

2. If Taxpayer is entitled to Treaty benefits with respect to its interest income, credits for foreign taxes paid by Taxpayer on or with respect to such income may be denied under domestic law.

FACTS:

Parent Co is a State R corporation headquartered in City, State S. Parent Co's common stock is traded on Market and has been quoted on that market since the company's initial public offering on Date 10, Year 4. Parent Co together with its direct and indirect subsidiaries designs, manufactures, markets, and sells Products worldwide to Customers. Parent Co directly owns multiple subsidiaries, which include: Taxpayer, a State R corporation; and Country B Entity, a Country B corporation. In the tax years at issue, Parent Co filed a consolidated income tax return in the United States that included Taxpayer.

From its incorporation on Date 21, Year 5, through Date 11, Year 8, Taxpayer did not engage in any activities in the United States or Country A, with the exception of carrying out certain formalities (e.g., making filings) required under State R state law. In the tax years at issue, Taxpayer engaged in the transactions described below (and continued to perform accounting activities and to make filings required under State R state law) but did not engage in any additional activities in the United States. Taxpayer represents that it was considered a State R Entity under State R Statute, which exempts from State R state income taxation any corporation whose in-state activities are

At the time Taxpayer received rights in intangible property from Parent Co, and throughout the Number I days Taxpayer held these rights, Taxpayer did not have resources (such as assets, facilities, or employees) to exploit these rights. Parent Co reflected Taxpayer's period of ownership of the rights in the intangible property by recording Number I days of income from the rights (representing w-percent of certain worldwide sales, or $bb) to Taxpayer via a book entry. This $bb was reported on the Parent Co consolidated federal income tax return for the tax year ending Date 16, Year 8.

Following its Transaction into Country A, Taxpayer carried out activities in Country A through its investments in other entities. Taxpayer held a x-percent partnership interest in Country A Entity, a Country A operating partnership that conducted selling activities for the Parent Co group in Country A through partnership employees. As discussed below, following the Transaction Taxpayer also became the owner of Country A Entity, Country F Entity, and a x-percent interest in Country G Entity.

I. **Date 12, Year 8, transfer of rights in intangible property from Parent Co to Taxpayer**

Pursuant to an "Asset Contribution Agreement" dated Date 12, Year 8, Parent Co contributed rights in certain existing intangible property ("the IP") in exchange for Number J shares of Taxpayer stock in an exchange treated by Parent Co as a non-recognition transaction under section 351.[1] Pursuant to the agreement, Parent Co assigned to Taxpayer "a nonexclusive and perpetual right to use, reproduce, modify, and create derivative works and improvements" with respect to the IP in a territory that included all countries and regions throughout the world except for those of Region P.

[1] No opinion is expressed as to whether this transaction qualifies as a section 351 transaction.

The Asset Contribution Agreement provides that the rights in the IP granted to Taxpayer "shall be exclusive as to [Parent Co's] use in [Taxpayer's] territory." The IP had a basis of $aa in Parent Co's hands. Taxpayer Advisor prepared an appraisal determining that the IP contributed to Taxpayer had a fair market value of $cc at the time of the exchange. Parent Co valued the Number J shares of Taxpayer stock received in the exchange at $cc.

II. **Transaction of Taxpayer into Country A**

The corporation law of State R allows an existing State R corporation to be in a foreign jurisdiction that permits the Transaction of a foreign corporation. Under the corporation law of State R, a State R corporation under the laws of a foreign jurisdiction may, at its option, file a Certificate. A corporation filing a Certificate continues to exist as a State R corporation to the same extent as prior to the filing of the Certificate. On Date 14, Year 8, Taxpayer filed a Certificate with the State R Official N indicating that Taxpayer had satisfied the formalities required under the corporation law of State R to approve the Transaction of Taxpayer into Country A. Taxpayer did not make any affirmative elections to discontinue its legal status in State R, and Taxpayer thus continued in existence as a duly incorporated legal entity subject to the corporation law of State R.

The corporation law of Country A Political Subdivision permits any company incorporated under the law of any jurisdiction other than Country A Political Subdivision to apply for a Certificate. A corporation in Country A Political Subdivision is governed under the law of Country A Political Subdivision and has all the rights and powers of a Country A Political Subdivision corporation. On Date 13, Year 8, Taxpayer petitioned the Official O of Country A Political Subdivision to request that Taxpayer be under the provisions of Political Subdivision Law. On Date 15, Year 8, Country A Political Subdivision issued Taxpayer a Certificate certifying that Taxpayer was in Country A Political Subdivision effective as of that date. Upon its Transaction into Country A Political Subdivision, for purposes of Country A tax law Taxpayer received a stepped-up basis in the IP equal to the fair market value of the IP as of the date of the Transaction — i.e., $cc.[2]

III. **Date 17, Year 8, transfer of rights in intangible property from Taxpayer to Country B Entity**

Pursuant to a "Contribution Agreement" dated Date 17, Year 8, Taxpayer contributed the IP to Country B Entity in exchange for shares of Country B Entity stock valued by the parties at $cc. For U.S. tax purposes, Taxpayer treated the exchange as a non-

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recognition transaction under section 351.[3] The Country B Entity shares comprised Number K shares of Country B Entity Type U stock (valued at $dd) and Number L shares of Country B Entity Type V stock (valued at $ee).

A. Treatment of the Date 17, Year 8, transfer of rights in intangible property for U.S. tax purposes

Taxpayer filed Form 926 ("Return by a U.S. Transferor of Property to a Foreign Corporation (under section 367)") with Parent Co's consolidated federal income tax return for the tax year ending Date 16, Year 9, to report the transfer of the IP to Country B Entity. Taxpayer indicates on Form 926 its treatment of the transfer as a section 351 transaction.

Taxpayer also filed Form 8833 ("Treaty Based Return Position Disclosure Under Section 6114 or 7701(b)") with Parent Co's consolidated federal income tax return for the tax year ending Date 16, Year 9. On Form 8833, Taxpayer provided the following explanation of its treaty-based return position:

> Under Article , Taxpayer is a resident of Country A, and is therefore subject to United States federal income tax only as prescribed in the Treaty. Taxpayer does not have a US permanent establishment, nor does it have any US source income. The taxpayer realized gain on the contribution of intangible property and the redemption of non-qualified preferred stock in the amount of $cc[4] and received partnership income from a Country A partnership investment in the amount of $mm.[5] These amounts represent business profits and/or capital gains that are not

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[3] No opinion is expressed as to whether this transaction qualifies as a section 351 transaction.

[4] It is not clear how Taxpayer determined this amount. Under section 367(d), a U.S. person that transfers intangible property to a foreign corporation in a section 351 transaction is generally treated as having sold such intangible property in exchange for a series of annual payments over the useful life of such property that are contingent upon the productivity, use, or disposition of the property and that are commensurate with the income attributable to the property. As a U.S. corporation that transferred intangible property to a foreign corporation in a section 351 transaction, Taxpayer would generally be required to include in gross income for its tax year ending Date 16, Year 9 (i.e., the tax year of the IP transfer to Country B Entity) a section 367(d) annual payment. No opinion is expressed as to the proper amount of the section 367(d) annual payment, if required, for Taxpayer's tax year ending Date 16, Year 9. Under section 362, Taxpayer generally would have taken a $aa basis in the shares of Country B Entity stock it obtained in the purported section 351 transaction. No opinion is expressed as to Taxpayer's basis in the Number L shares of Country B Entity Type V stock that were redeemed on Date 23, Year 8, or the amount of gain Taxpayer realized for U.S. tax purposes when these shares were redeemed.

[5] Taxpayer's identification of this amount as "partnership income from a Country A partnership investment" appears to have been a mistake. Taxpayer reported this amount, which comprises interest income from three sources minus expenses, as its taxable income on its Country A income tax return for its tax year ending Date 16, Year 9. See infra note 11.

subject to US tax when derived by a resident of Country A pursuant to Articles [6] and [7] of the Treaty.

In summary, for U.S. tax purposes Taxpayer took the position that it realized gain on the contribution of the IP to Country B Entity but that this gain was not subject to U.S. tax under the terms of the Treaty because Taxpayer was a resident of Country A for Treaty purposes.

B. Treatment of the Date 17, Year 8, transfer of rights in intangible property for Country A tax purposes

As noted above, for Country A tax law purposes Taxpayer's basis in the IP was stepped up to the IP's fair market value upon Taxpayer's Transaction into Country A Political Subdivision. On its Country A income tax return for the tax year ending Date 16, Year 9, Taxpayer accordingly took the position that it did not realize gain on the transfer of the IP to Country B Entity because Taxpayer's $cc basis in the IP was equal to the value of the Country B Entity stock received in the exchange.

IV. Date 17, Year 8, cost sharing agreement between Parent Co and Country B Entity

On Date 17, Year 8, Parent Co and Country B Entity entered into a "Research and Development Cost Sharing Agreement" (CSA). The parties intended the CSA to constitute a "cost sharing agreement" within the meaning of Treas. Reg. § 1.482-7(a)(1). Under the CSA, Parent Co and Country B Entity agreed to share the costs and risks of R&D activities with respect to Products. The CSA provided that the R&D costs covered by the agreement would be borne w-percent by Country B Entity and y-percent by Parent Co. Parent Co represents that no buy-in payment was required under Treas. Reg. § 1.482-7(g)(1) and (2) because Country B Entity already held rights to the relevant pre-existing technology in its respective territory (pursuant to the Date 17, Year 8, "Contribution Agreement") and the CSA contemplated a grant of rights solely with respect to future technology to be developed under the CSA.[8]

For the tax year ending Date 16, Year 9, Country B Entity made a cost sharing payment of $ff to Parent Co for its share of R&D expenses under the CSA. Country B Entity made the cost sharing payment using funds from an intra-company dividend (in the

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[6] Paragraph of Article generally provides that the business profits of a resident of a Contracting State will be taxable only in that State unless the resident carries on business in the other Contracting State through a permanent establishment situated therein.

[7] Paragraph of Article provides that gains from the alienation of any property will generally be taxable only in the Contracting State of which the alienator is a resident. Thus, under Article , such gains derived by a resident of Country A are generally taxable only in Country A. The Year 3 TE explains that the term "alienation" as used in Article "

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[8] No opinion is expressed as to the validity of the CSA or the adequacy of the buy-in under the CSA.

amount of $gg) it received from Country C Entity, a Country C company wholly owned by Country B Entity. Country C Entity is an operating company that performs Functions for the Parent Co group. Country B Entity filed a check-the-box election, effective Date 17, Year 7, to treat Country C Entity as a branch of Country B Entity for U.S. tax purposes. For U.S. tax purposes, payments made pursuant to a cost sharing arrangement (other than Treas. Reg. § 1.482-7(g) buy-in payments) generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. Treas. Reg. § 1.482-7(h)(1).

V. Date 23, Year 8, redemption of Country B Entity Type V stock

On Date 23, Year 8, Country B Entity redeemed the Number L shares of Country B Entity Type V stock held by Taxpayer, in exchange for the following consideration with a total value of $ee: a promissory note issued by Parent Co to Country B Entity[9] ("Note 1") ($hh face value plus $jj accrued interest); a second promissory note ($kk) ("Note 2"); and cash ($ll).

A. Treatment of the Date 23, Year 8, redemption of Country B Entity Type V stock for U.S. tax purposes

As stated above, Taxpayer's Form 8833, filed with Parent Co's consolidated federal income tax return for the tax year ending Date 16, Year 9, stated that Taxpayer realized gain on the redemption of non-qualified preferred stock.[10] Taxpayer took the position that this gain was not subject to U.S. tax under the terms of the Treaty because Taxpayer was a resident of Country A for Treaty purposes.

B. Treatment of the Date 23, Year 8, redemption of Country B Entity Type V stock for Country A tax purposes

For Country A tax purposes, it appears that Taxpayer took a fair market value basis in the Number L shares of Country B Entity Type V stock and thus did not realize a gain upon the shares' redemption.

VI. Reporting of Taxpayer's income for its tax year ending Date 16, Year 9

Taxpayer reported income on the Country A income tax return for its tax year ending Date 16, Year 9, in the amount of $mm,[11] on which it paid Country A federal and

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[9] On Date 20, Year 8, Parent Co borrowed $hh from Country B Entity in exchange for an interest-bearing promissory note. Country B Entity obtained the bulk of these funds by selling Number M shares of Country B Entity Type T stock to Country D Entity for $ii in cash on Date 19, Year 8.

[10] Taxpayer's Form 8833 reported a single amount, which combined its gain on the contribution of the IP and its gain on the redemption of non-qualified preferred stock. No opinion is expressed as to the amount of gain Taxpayer realized for U.S. tax purposes when the Number L shares of Country B Entity Type V stock were redeemed.

[11] Taxpayer determined its Country A taxable income for its tax year ending Date 16, Year 9, as follows:

provincial taxes in the amount of $ss. Parent Co's Country A taxable income comprised interest income from Note 1, Note 2, and an "investment." Parent Co included Taxpayer's Country A taxable income of $mm on its U.S. consolidated income tax return for its tax year ending Date 16, Year 9. Taxpayer eliminated this income from the return through a favorable Schedule M-1 adjustment, citing the Treaty.[12] Taxpayer explained on its Form 8833 that, as a resident of Country A, it was not subject to U.S. tax on this income (identified, apparently incorrectly, as partnership income from a Country A partnership investment) under the Treaty. Parent Co claimed foreign tax credits of $ss on the U.S. consolidated income tax return for its tax year ending Date 16, Year 9, for the federal and provincial taxes paid in Country A.

VII. **Rationale for the transactions**

According to Parent Co, the transactions at issue took place within the context of a restructuring of Parent Co's worldwide business operations that was intended to facilitate domestic and international expansion and to minimize its federal, state, and foreign tax expenses. As part of the restructuring, Taxpayer became the owner of certain foreign affiliated companies, including Country F Entity, Country G Entity (x-percent interest), Country E Entity, and Country H Entity.

A stated objective of the initial transfer of the IP from Parent Co to Taxpayer was state tax savings. This transfer appears to have allowed Parent Co to save approximately $tt in State S state income taxes. We understand that the state tax savings were achieved because, under the State S unitary state tax system, the total income subject to tax includes not only the income of the specific corporation operating in State S (i.e., Parent Co) but also the income of all of its affiliates engaged in the same unitary business outside the state. Transferring the IP to Taxpayer "isolated" the IP in State R. In other words, following the transfer, we understand that Parent Co and Taxpayer were not unitary businesses for State S state income tax purposes, and income attributable to the IP (most significantly, the gain derived from the transfer of the IP by Taxpayer to Country B Entity) was accordingly not subject to State S state income tax.[13] We additionally understand that, as a State R Entity, Taxpayer may have received favorable

Interest Income – Note 2	$nn
Interest Income – Note 1	$oo
Interest Income – investment	$pp
Total Income	$qq
Total Expenses	$rr
Taxable Income	$mm

[12] Assuming Treaty benefits are available with respect to Taxpayer's interest income, no opinion is expressed as to whether Taxpayer correctly applied the Treaty to such income. It appears that a portion of this interest income – Note 1 interest – would be U.S. source interest income potentially subject to U.S. tax under Article (Interest) of the Treaty.

[13] We understand that Parent Co achieved similar savings in other states with unitary state tax systems where Parent Co reported and paid state income taxes.

State R state income tax treatment with respect to the gain derived from the transfer of the IP to Country B Entity.

A stated objective of the subsequent transfer of the IP from Taxpayer to Country B Entity was to avoid a buy-in payment (and U.S. income tax on such buy-in payment) in connection with the CSA between Parent Co and Country B Entity discussed above. This transfer also served to shift the income attributable to the IP from Taxpayer to Country B Entity, a foreign entity.

Parent Co concluded that there were financial and commercial advantages, as well as significant foreign tax savings, to be obtained by Taxpayer into Country A. Taxpayer was intended to serve as an international holding company for Parent Co's businesses in Country A, Region Q, and Country G, and as an investment vehicle for future foreign expansion. The Transaction was also intended to allow Taxpayer to benefit from Country A's tax treaty network, which includes certain countries with which the United States does not currently have treaties. Parent Co concluded that some of Country A's income tax treaties provided certain benefits that are not provided in the United States income tax treaty with the same country. We have not evaluated the purported benefits, if any, to Taxpayer from Country A's tax treaty network.

LAW AND ANALYSIS:

ISSUE 1 – TAXPAYER IS NOT ENTITLED TO BENEFITS UNDER THE TREATY

For purposes of this discussion, we assume that Taxpayer continued to be classified as a domestic corporation under section 7701(a)(4) after it was into Country A Political Subdivision, and that it therefore remained subject to U.S. federal income tax on its worldwide income. We also assume that under Country A law, pursuant to Taxpayer's Transaction into Country A Political Subdivision, Taxpayer became a Country A corporation under Country A law that is fully liable to tax in Country A. Accordingly, Taxpayer would be fully liable to tax under the domestic rules of both the United States and Country A. The first issue we address below is the extent, if any, to which the Treaty limits the application of the Internal Revenue Code under the facts of this case. After briefly reviewing the standards of treaty interpretation, relevant treaty provisions and technical explanations and other history of the provisions, we then consider their application to the present facts.

I. **Treaty Provisions**

The starting point in treaty interpretation is the language of the treaty itself. Eastern Airlines, Inc. v. Floyd, 499 U.S. 530, 534 (1990); Sumitomo Shoji America, Inc. v. Avagliano, 457 U.S. 176, 180 (1982). If the treaty language itself is clear, it is controlling so long as the words do not effect a result that is inconsistent with the intent or expectations of the signatories. Eastern Airlines, 499 U.S. at 534; Sumitomo Shoji America, 457 U.S. at 180; Maximov v. United States, 373 U.S. 49, 54 (1963). In order to ensure its fair operation, a treaty must be interpreted in a manner that will give effect to the intent of the parties, as ascertained from the text, context, and history of the treaty. Air France v. Saks, 470 U.S. 392 (1985); Sullivan v. Kidd, 254 U.S. 433 (1921). A textual analysis of a treaty provision will require review of the context within the treaty of the language being construed. Thus, the interaction of the specific operative language with that of other provisions in the treaty must be considered. O'Connor v. United States, 479 U.S. 27 (1986); Sullivan, 254 U.S. at 439. The Treaty provisions relevant to Taxpayer's position are the residence rules of Article , the miscellaneous rules and saving clause of Article , and the Limitation on Benefits provisions of Article .

A. **Article (Residence)**

1. **Definition of "Resident"**

Paragraph of Article of the Treaty provides in relevant part:

The Technical Explanation of the Treaty prepared by the Treasury Department in Year 3 (the "Year 3 TE") states that

Thus, a corporation is a resident of the United States under paragraph if either (i) it is incorporated in the United States or (ii) it elects under the Code to be treated as a U.S. resident.

2. **Corporate Tiebreaker Rule**

Paragraph of Article provides "tiebreaker" rules for corporations that are treated as residents of both the United States and Country A.

a. Original Tiebreaker Rule

Prior to amendment by the Year 5 Protocol, Article

was part of the treaty that was signed on Date 22, Year 1. The Year 3 TE stated in relevant part:

Thus, under the pre-Year 5 tiebreaker rule, if a company qualified as a resident of both Country A and the United States under paragraph of Article , the company would be treated as a resident of the country in which it had been originally created, even if the company was subsequently incorporated in another country.

b. Tiebreaker Rule as Amended by the Year 5 Protocol

The Year 5 Protocol added to Article :

(Emphasis added.) The Treasury Department's Technical Explanation of the Year 5 Protocol[14] (the "Year 5 TE") states that

and that

B. **Article (Miscellaneous Rules)**

1. **Paragraph**

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Paragraph of Article provides that the Treaty will not be applied to restrict any benefits that would otherwise be available under the laws of either country: "

" The Year 3 TE explains that

The Year 3 TE also clearly states, however, that Article does not authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Treaty. The Year 3 TE illustrates inconsistent taxpayer choices between the Code and the Treaty as follows:

2. **Saving Clause**

Paragraph of Article provides a "saving clause" that allows each country to tax (i) its residents and (ii) in the case of the United States, certain other persons as if the Treaty had not come into effect:

(Emphasis added.) Paragraph of Article provides a number of exceptions to the saving clause that are not relevant here.[15]

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C. **Article (Limitation on Benefits)**

The Year 5 Protocol added a limitation on benefits (LOB) article to the Treaty in new Article . The purpose of the LOB article is to prevent treaty shopping by limiting the benefits granted by the United States under the Treaty to those persons whose residence in Country A is not motivated by the existence of the Treaty. Paragraphs through set forth rules for determining when a Country A resident has a sufficient nexus to Country A to be entitled to Treaty benefits. These rules complement the domestic anti-abuse provisions that apply to specific transactions or arrangements, including business purpose, substance-over-form, step transaction, conduit principles, and other anti-avoidance rules.

Paragraph of Article generally provides that, for the purposes of the application of the Treaty by the United States, a person that is not a “qualifying person” is not entitled to any of the benefits of the Treaty. Paragraph of Article identifies certain residents of Country A that are “qualifying persons” for purposes of Article . Article provides, in relevant part, that qualifying persons include a resident of Country A that is:

The Year 5 TE explains that “

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Article is not reciprocal, except for paragraph , because Country A prefers to rely on its general domestic anti-avoidance rules. Paragraph provides:

The Year 5 TE refers to the Commentaries to the OECD Model Tax Convention on Income and on Capital (the "OECD Model"). Paragraph 7 of the Commentary to Article 1 of the OECD Model states in part that "[t]he purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion."

II. Discussion

A. Taxpayer Should Be Denied Benefits Because It Is Not a Resident of Country A under Article

Under Article , Taxpayer became a resident of Country A for the first time when it was incorporated in Country A Political Subdivision by way of a Transaction; but it also remained a resident of the United States by reason of its place of incorporation in State R. Thus, Taxpayer was a dual resident of the United States and Country A solely by reason of its Transaction into Country A. In order to resolve Taxpayer's residency for Treaty purposes, it is necessary to carefully examine the language of the tiebreaker rule in Article . According to the discussion of the of Article in the Year 3 TE, it was already anticipated that a jurisdiction might allow local incorporation of an entity that is already organized and incorporated under the laws of another country. The Year 3 TE further provides that the rule was drafted to provide certainty in both the United States and Country A with respect to the treatment of such an entity for purposes of the Treaty. The rule treats such a company as solely a resident of the country where the company was originally created. In this case, Taxpayer would be solely a resident of the United States, as the place in which Taxpayer was originally created. Thus, unless the of Article applies to reverse the determination of residency, the applicable Treaty articles would be applied to Taxpayer as if it were a resident of the United States.

The language of the of Article applies to a company that (1) was created in a Contracting State, (2) is a resident of both Contracting States, and (3) is at any time in the other Contracting State in accordance with the corporate law in that other State. In order to give meaning to the plain language of the , it is reasonable to construe the second "dual residency" condition as a condition that must be met <u>before</u> the Transaction – <u>i.e.</u>, a company cannot meet the dual residency condition solely by reason of its Country A residence <u>following</u> a Transaction. Because Taxpayer was not a resident of both the United States and

Country A before the Transaction, the of Article does not by its terms apply. Thus, Taxpayer is a resident of the United States for Treaty purposes, and is not entitled to claim Treaty benefits as a resident of Country A.

Dual residency before a Transaction is possible in certain situations. Under Country A common law, a corporation is resident for tax purposes in the country in which the corporation exercises its central management and control. As a result, a domestic corporation (as defined in section 7701(a)(4)) that is managed and controlled in Country A could be resident in the United States for U.S. tax law purposes and resident in Country A for Country A tax law purposes.[16] The Senate Foreign Relations Committee specifically notes:

The interpretation of the as a limitation on the scope of the is also consistent with the introductory language of the , which says that it applies " ." The originally applied to all dual resident situations, including dual incorporations. The Year 1 Technical Explanation to paragraph of Article states that by referencing the tie-breaker rule is controlled by the State of the company's original creation. The , therefore, limits the application of the first sentence to dual incorporation situations where the

company did not already have its central management and control in Country A. Thus, the tiebreaker only favors Country A where the company has its central management and control in Country A as well as its place of incorporation.

Accordingly, Taxpayer's claim of Treaty benefits rests on an incorrect interpretation of the of Article to award taxing jurisdiction to Country A. As explained below, however, even if Taxpayer's interpretation of Article were accepted, we conclude nonetheless that Taxpayer is not entitled to Treaty benefits.

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B. Taxpayer Should Be Denied Treaty Benefits as a Company That Elected To Be Treated as a Domestic Corporation under the Saving Clause

The Article saving clause allows the United States to continue to tax its citizens and companies electing to be treated as domestic corporations as if there were no Treaty. Thus, U.S. citizens and companies electing to be treated as domestic corporations are subject to U.S. tax on their worldwide income even if they are treated as residents of Country A under Article after application of the tiebreaker rules.

As discussed below, in the tax years at issue State R corporation law provided that a State R corporation that in a jurisdiction outside the United States could, at its option, either (1) continue to exist as a State R corporation or (2) cease to exist as a State R corporation. Taxpayer into Country A Political Subdivision and, pursuant to the applicable provision of State R corporation law, elected to file a Certificate with the State R Official N – and thereby continue its existence as a State R corporation. Taxpayer took active steps to remain duly incorporated in (and subject to the corporation law of) State R. Parent Co accordingly included Taxpayer on Parent Co's consolidated income tax return as a domestic corporation for its tax year ending Date 16, Year 8, and subsequent tax years. The retention of Taxpayer's State R charter and Taxpayer's subsequent inclusion on Parent Co's consolidated income tax returns should be considered an election to treat Taxpayer as a domestic corporation within the meaning of Article . Accordingly, even if Taxpayer were treated as a resident of Country A under Article for purposes of the Treaty, the Service may invoke the saving clause and tax Taxpayer on its worldwide income as if the Treaty had not come into effect because Taxpayer is a company that has elected to be treated as a domestic corporation.

Taxing Taxpayer as if there were no Treaty gives effect to the plain language of Article . Taxpayer elected to be treated as a domestic corporation by choosing to into Country A in a manner that would preserve its status as a domestic (State R) corporation and permit its inclusion in Parent Co's consolidated income tax returns following its Transaction. Thus, this position is fully supported by the explicit wording of Article . Moreover, the Year 3 TE does not compel a more narrow interpretation of Article . As explained below, when read in light of the purpose of the saving clause and the domestic legal framework in which it was originally intended to operate, the language of the Year 3 TE – which refers to " " – should not be interpreted to preclude the United States from invoking Article in the present factual context.

Other than providing for an appropriate income tax credit with respect to income tax paid or accrued to Country A by a company electing to be treated as a domestic corporation, Article does not otherwise limit the United States' right to tax companies covered by the Article saving clause.

We understand that at the time the Year 3 TE was drafted, a domestic corporation that into Country A from the United States could not, in any state, have retained its corporate charter and thereby continue to be treated as a domestic corporation for purposes of the Code. For example, prior to Year 6, section of the State R Law provided that a State R corporation could transfer to a jurisdiction outside the United States but required that, upon such transfer, the corporation cease its existence as a State R corporation. Thus, at the time the Treasury Department prepared the Year 3 TE, dated Date 18, Year 3,

. Moreover, other means of "domesticating" a Country A corporation more generally (regardless of inclusion in a consolidated group) were not available at the time the Year 3 TE was drafted.[17] As a result, the Year 3 TE's reference to , while understandable based on the then prevailing rules,

[17] Other Code based elections permitting foreign corporations to be treated as domestic corporations were added after the original (Year 2) and revised (Year 3) versions of the TE to Article . For example, section 269B (effective July 18, 1984) was added to the Code by the Deficit Reduction Act of 1984, P.L. 98-369, section 953(d) was added to the Code by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, and section 943(e)(1) was added to the Code by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, P.L. 106-519.

is by no means any limitation on the scope of Article . Instead, Article is clearly broad enough to cover the present situation.

The State R corporation law procedure under which a State R corporation may transfer to a jurisdiction outside the United States and cease its existence as a State R corporation remained available in the tax years at issue. In Year 6, however, section of the State R Law was amended to permit a State R corporation to in a jurisdiction outside the United States without terminating its State R existence – and, as a result, remain a section 1504(b) "includible corporation" following such Transaction. This change to State R law thus created a means by which certain Country A corporations could be included in a U.S. consolidated income tax return that did not exist at the time the Year 3 TE was drafted. The broad language of Article itself – " " – should be construed to include a domestic corporation that uses a state corporation law procedure to elect to be treated as a domestic corporation and, as a result, be included in a consolidated return. In this context, we do not believe it is significant that the Year 3 TE discusses solely , especially when state corporation law Transaction procedures like that used by Taxpayer did not exist at the time the Year 3 TE was drafted. Such a construction also gives best effect to the intent of the parties to the Treaty, as expressed in clear statements by the Treasury Department (and Country A Agency) that it was not contemplated that a U.S. corporation that was a resident of Country A after application of Article should benefit from the treaty if it remained part of a U.S. consolidated income tax return. Neither country contemplated that corporations should use Article to assert inconsistent positions as to their Treaty versus domestic law tax residence.[18]

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C. Taxpayer May Not Take Inconsistent Positions under the Treaty and the Code

The general rules for application of the Treaty in Article do not permit the Parent Co group to treat Taxpayer as a domestic corporation for purposes of the Code (e.g., for purposes of the consolidated income tax return) and simultaneously treat Taxpayer as a foreign corporation for purposes of the Treaty. As noted above, the Year 3 TE makes clear that Article does not authorize a taxpayer to make inconsistent choices between the rules of the Code and the rules of the Treaty. Accord Rev. Rul. 84-17, 1984-1 C.B. 308 (taxpayer cannot elect treaty provisions with respect to the taxability of business gain that is in part attributable to a permanent establishment and in part not attributable thereto, while in the same tax year elect the provisions of the Code with respect to a non-attributable business loss). Construction of the treaty by the agency in the executive branch charged with administration of the treaty is entitled to "great weight." Kolovrat v. Oregon, 366 U.S. 187, 194 (1961); Restatement (Third) of the Foreign Relations Law of the United States § 326(2) (1987).

If Taxpayer were a resident of Country A under the Treaty, Taxpayer would generally be entitled to claim benefits under the Treaty. In the alternative, Taxpayer would be entitled to apply the Code and join the Parent Co group consolidated return as a domestic corporation. However, Article does not permit Taxpayer to apply the Code and Treaty in combination to reach a result that is more favorable than the result under the Code or the Treaty individually. The latter is what occurred in the present case. By simultaneously claiming Treaty benefits as a resident of Country A and applying certain Code provisions as a resident of the United States, Taxpayer asserted that it could:

(1) Join the Parent Co group consolidated return as a domestic corporation;

(2) Include on the consolidated return Taxpayer's gain on the contribution of the IP and on the redemption of the Country B Entity Type V stock;

(3) Include on the consolidated return Taxpayer's interest income and claim U.S. foreign tax credits for Country A taxes paid with respect to such income; but at the same time

(4) Eliminate from the consolidated return Taxpayer's gain on the IP contribution, its gain on the Country B Entity stock redemption, and its interest income, citing the Treaty.

Taxpayer's position under the Code is inconsistent with the structure and underlying assumptions of the Treaty. After application of the tiebreaker rules in Article , a taxpayer that would be considered a resident of both the United States and Country A under each country's domestic law is a resident of, and subject to full tax liability in, either the United States or Country A, but not both. Because Taxpayer chose to apply the Code and to join the Parent Co group's consolidated return as a domestic corporation that is liable to tax on its worldwide income, Taxpayer should not be allowed simultaneously to claim benefits under the Treaty that are not available to a corporation that is fully liable to tax in the United States. Taxpayer's inclusion on the consolidated return for the tax year ending Date 16, Year 8, and subsequent tax years should be treated as a waiver of any benefits to which Taxpayer would have been entitled under the Treaty.

D. The LOB Article Permits Denial of Benefits that Conflict with the Purpose and Intent of the Treaty

A resident of Country A must also generally be a "qualifying person" under Article to be entitled to benefits under the Treaty.

Article provides a two-part test under which certain entities may be qualifying persons, based on ownership and "base erosion." We assume for purposes of the remainder of this discussion that Taxpayer would satisfy the ownership test[19] and the base erosion test.[20]

The anti-treaty shopping rules in Article that determine whether a person has sufficient nexus to Country A to be entitled to Treaty benefits are complemented by a general anti-abuse provision in paragraph of Article . Paragraph states that nothing in the Treaty shall be construed to restrict in any manner the right of a Contracting State to deny Treaty benefits where to do otherwise would result in an abuse of the Treaty. As explained in the Year 5 TE, paragraph was intended to

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[19] Taxpayer would satisfy the Article ownership test if 50 percent or more of the vote and value of its shares were directly or indirectly owned by qualifying persons or citizens or residents of the United States. Taxpayer is wholly-owned by Parent Co, a corporation resident in the United States whose common shares are traded on Market. [redacted]

[20] Taxpayer would satisfy the base erosion test of Article if the amount of expenses that are paid or payable by Taxpayer to persons that are not qualifying persons or U.S. citizens or residents, and that are deductible from gross income, were less than 50 percent of Taxpayer's gross income. The test is applied for the tax year immediately preceding the period for which the qualifying person test is being applied (or, in the case of the company's first tax year, that tax year). In determining whether Taxpayer is a qualifying person for its tax year ending Date 15, Year 9, the base erosion test would thus use Taxpayer's expense and gross income amounts from its tax year ending Date 16, Year 8. [redacted]

confirm that Article did not limit the right of each Contracting State to invoke applicable domestic anti-abuse rules:

To allow Taxpayer, a domestic corporation, to apply the Treaty to exclude from the consolidated return its gain on the transfer of the IP to Country B Entity and its gain on the redemption of the Country B Entity Type V stock, based on its purported status as a resident of Country A for Treaty purposes, would result in an abuse of the Treaty. Similarly, to allow Taxpayer to apply the Treaty to exclude certain interest income from the consolidated return, also based on its purported status as a resident of Country A for Treaty purposes, while at the same time claiming foreign tax credits in the United States for taxes associated with the excluded income, would result in an abuse of the Treaty. Therefore, it is appropriate to apply domestic law to prevent the abuse.

It is a well-settled principle of U.S. law that courts should look beyond the literal language of a provision if reliance on that language would defeat the purpose of the provision. Bob Jones University v. United States, 461 U.S. 574, 586 (1982); Brown v. Duchesne, 19 How. 183, 194 (1857); Albertson's v. Commissioner, 42 F.3d 537, 541 (9th Cir. 1994), cert. denied, 516 U.S. 807 (1995). In the treaty context, U.S. courts have long been willing to look beyond the literal terms of a treaty when a taxpayer has claimed benefits that conflict with the purpose and the intent of the treaty. For example, the Fifth Circuit held in Johansson v. United States, 386 F.2d 809 (5th Cir. 1964), that a taxpayer was not entitled to the benefits available under the "commercial travelers' exception" under the former U.S.-Switzerland income tax treaty where the practical reasons for the exemption were not present in the taxpayer's case. The practical reason for the commercial travelers' exception was to allow corporations of one Contracting State to send agents and employees into the other Contracting State without subjecting them to tax in the other Contracting State. That practical reason was inapplicable where the individual was "only technically, if at all, employed by a paper Swiss corporation." Id. at 814. Similarly, the Court of Claims has denied treaty benefits in instances in which the taxpayer met the literal terms of a relief provision in a treaty under circumstances that did not present the potential harms that the treaty provisions were intended to alleviate. See Great-West Life Assurance Co. v. United States, 678 F. 2d 180 (Ct. Cl. 1982); Compagnie Financiere de Suez et de l'Union Parisienne v. United States, 203 Ct. Cl. 605 (1974).

In this case, relying solely on Taxpayer's interpretation of the language of the of Article would defeat the purpose of the provision. The purpose of that tiebreaker rule is to provide certainty with respect to the residence of a corporation in specific factual contexts in which the corporation is created in one Contracting State and into the other Contracting State. Underlying the addition of this tiebreaker rule was an assumption that a corporation would not retain its status as a corporation resident in the country in which it was created, whether or not it retained its corporate charter in that country.[21] As discussed above, at the time this tiebreaker rule came into force, a domestic corporation that into Country A could not, in any state, have retained its corporate charter and thereby continue to be treated as a domestic corporation for purposes of the Code. Then, in Year 6, State R changed its state corporation law to permit a State R corporation to outside the United States without losing its status as a State R corporation and, thus, as a U.S. resident corporation.

As discussed above, Taxpayer has interpreted the tiebreaker rule to provide that Taxpayer is a resident of Country A for Treaty purposes. Application of Taxpayer's interpretation of the tiebreaker rule in this factual context does not, however, provide certainty with respect to Taxpayer's residence, but rather creates a situation where Taxpayer is able to pick and choose the treatment it wants. Under Taxpayer's interpretation, Taxpayer was able, in effect, to be treated as a resident of Country A for purposes of the Treaty but remain a resident of the United States under domestic law. Under the authority of the cases cited above, the United States may thus look beyond Taxpayer's hypertechnical interpretation of the language of the of Article to give effect to the purpose and intent of the provision to provide certainty with respect to the residence of a corporation.

ISSUE 2 – IF TAXPAYER IS ENTITLED TO AN INCOME EXCLUSION UNDER THE TREATY, FOREIGN TAX CREDITS WITH RESPECT TO SUCH INCOME SHOULD BE DISALLOWED UNDER THE CODE

If it is determined that Taxpayer may simultaneously be treated as a domestic corporation that is includible in the Parent Co group consolidated return and as a nonresident corporation that is entitled under the Treaty to exclude certain foreign source interest income from the Parent Co group's consolidated taxable income,[22] we

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22 As noted above, assuming Treaty benefits are available with respect to Taxpayer's interest income, no opinion is expressed as to whether Taxpayer correctly applied the Treaty to such income. A portion of this interest income appears to be U.S. source interest income potentially subject to U.S. tax under Article of the Treaty.

believe that credit for foreign taxes paid or deemed paid by Taxpayer on or with respect to such excluded income is improper, under the authority of Marsman v. Commissioner, 18 T.C. 1 (1952), aff'd in relevant part, 205 F.2d 335 (4th Cir. 1953), aff'd, 216 F.2d 7 (1954), cert. denied, 348 U.S. 943 (1955). Accordingly, the Service should disallow the claimed credits, in reliance on Marsman, as a protective measure, in addition to making the adjustments required by proper application of the Treaty, which would exclude Taxpayer from the Parent Co group consolidated return or deny it the right to exclude its foreign source income from the consolidated return.

In Marsman, prior to September 22, 1940, the taxpayer was a nonresident alien. In 1941, after becoming a U.S. resident, the taxpayer paid a tax deficiency to the Commonwealth of the Philippines that was attributable to income from periods before she was a U.S. resident. The taxpayer claimed the back taxes paid to the Philippines as a cash basis foreign tax credit against her U.S. income tax liability for 1941. The Fourth Circuit affirmed the Tax Court's holding that, despite the taxpayer's literal entitlement to the credit under the words of the applicable statute, no portion of the tax paid to the Philippines for periods when the taxpayer was a nonresident was allowable as a foreign tax credit in the United States.

Noting that the Supreme Court has held that the primary purpose of the foreign tax credit is to mitigate the "evils of double taxation," the Fourth Circuit found:

> This purpose will not be served and double taxation will not be avoided by allowing the credit now sought by the taxpayer because the 1938 and 1940 Philippine income taxes paid by the taxpayer in 1941 were imposed upon income which was never subjected and could not be subjected to the United States income taxes for the reason that the taxpayer was a nonresident of the United States until September 22, 1940 and the Philippine income during those two years was derived from sources outside the United States.

205 F.2d at 343 (emphasis added). Because the taxpayer's nonresident status in 1938 and 1940 precluded the United States from taxing her income in those years, there was no possibility of double taxation and the credits were properly disallowed. Id.

Marsman is distinguishable from the line of cases holding that a foreign tax imposed in connection with a transaction that does not give rise to income for U.S. tax purposes may nonetheless be creditable, subject to the limitations of section 904. See Schering Corp. v. Commissioner, 69 T.C. 579 (1978), acq., AOD 1981-31; Helvering v. Campbell, 139 F.2d 865 (4th Cir. 1944); Dexter v. Commissioner, 47 B.T.A. 285 (1942), acq., 1948-2 C.B. 1; Brace v. Commissioner, 11 T.C.M. (CCH) 906 (1952). Unlike Marsman, in the cited cases the taxpayers were fully subject to U.S. taxing jurisdiction. Some of their income that was taxed by the foreign jurisdiction was fully or partially exempt from U.S. tax, not on the basis of the taxpayer's nonresident status, but because the applicable Code rules determined a different amount of taxable income. Marsman is not inconsistent with these cases because its holding is properly construed as limited to denying credits in circumstances where the United States lacks the jurisdiction to tax income because of the taxpayer's nonresident status.

If the Parent Co group succeeds in its argument that the United States has no jurisdiction to tax Taxpayer's foreign source interest income by virtue of Taxpayer's nonresident status under Article of the Treaty, then under the principles of Marsman the associated taxes are not allowed as a credit. As in Marsman, the taxpayer here is attempting to claim foreign tax credits while excluding the associated income from tax on the basis of its nonresident status. If pursuant to the Treaty the United States has ceded to Country A the jurisdiction to tax Taxpayer on its foreign source income by treating Taxpayer as a nonresident, then under Marsman Taxpayer may not claim credits for foreign taxes paid or accrued, or deemed paid or accrued, during periods when Taxpayer claims nonresident status.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

By:___________________________
ELIZABETH U. KARZON
Chief, Branch 1
Office of Associate Chief Counsel
(International)