**Office of Chief Counsel**
**Internal Revenue Service**
# Memorandum

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subject: Applicability of Dividend Characterization under Treaty to Foreign Tax Credit Limitations

This Chief Counsel Advice responds to your request for advice with respect to claims by Taxpayer for foreign tax credits asserted to arise under the U.S.-U.K Income Tax Treaty ("Treaty")[1] in connection with certain payments in lieu of dividends (hereinafter "substitute payments") received with respect to borrowed securities. In accordance with section 6110(k)(3) of the Internal Revenue Code of 1986, as amended (the "Code"), this Chief Counsel Advice should not be cited as precedent.

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1 *Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains*, signed on December 31, 1975, and entered into force on April 25, 1980, 31 U.S.T. 5668, *reprinted in* 1980-1 C.B. 394. The Treaty applicable during the years at issue was superseded by a treaty that entered into force on March 31, 2003. *See Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains*, signed on July 24, 2001, entered into force on March 31, 2003, S. Treaty Doc. No. 107-19 (2002), 2001 WL 34315021. Under Article 29(3) of the current treaty, however, taxpayers are permitted to rely on more favorable provisions in the old treaty for an additional twelve months. In addition, Article V of the protocol dated July 19, 2002, clarifies that the provisions of the old treaty relating to the U.K. resident shareholder credit cease to apply for dividends paid on or after May 1, 2003. Taxpayers could elect to extend those provisions of the old treaty to cover dividends paid before May 1, 2004. The current treaty does not retain any of the old treaty's special provisions relating to the U.K. resident shareholder credit.

LEGEND

Taxpayer =
Subsidiary =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Amount X =
Amount Y =

ISSUES

1. Whether Taxpayer adequately substantiated its claim for foreign tax credits purported to arise under Article 10 of the Treaty from amounts deemed withheld from deemed refunds of Advance Corporation Tax ("ACT") by the United Kingdom ("U.K.") in respect of substitute payments.
2. Whether section 901(k), which disallows a foreign tax credit for withholding taxes imposed on certain dividends, applies to substitute payments and deemed refunds of ACT with respect to such payments that Article 10 of the Treaty treats as dividends.

CONCLUSIONS

1. No. Section 905(b) requires taxpayers to substantiate all claims for foreign tax credits. Substantiation generally requires written documentation from foreign taxing authorities that taxes were paid. With respect to amounts treated under the Treaty as tax withheld from ACT refunds with respect to dividends paid prior to April 6, 1999, Taxpayer conceded that it neither applied for nor received any refunds from which such creditable taxes might have been withheld. Thus, Taxpayer failed to provide the requisite evidence that it paid any such taxes. Amounts treated under the Treaty as tax withheld from ACT refunds with respect to dividends paid on or after April 6, 1999, were subject to the same requirement, but taxpayers could elect under Rev. Proc. 2000-13 to claim credits for amounts deemed withheld from deemed ACT refunds without actually filing refund claims by making an election on Form 8833. Because Taxpayer failed to make that election or to establish that it was eligible to make the election, it remains subject to the evidentiary requirements under section 905(b) that it has not satisfied.

2. Yes. Article 10(2)(a)(iii) of the Treaty provides that the aggregate of the amount of the dividend (as defined in Article 10(3)) and the amount of the refundable tax credit referred to in Article 10(2)(a)(i) and (ii) paid by the U.K. to a U.S. resident shall be treated as a dividend for U.S. tax credit purposes. Pursuant to Article 23, such treatment as a dividend encompasses both the availability of foreign tax credits for amounts withheld from the ACT refund and any limitations on those credits. Even if Taxpayer had established its entitlement to ACT refunds with

respect to the substitute payments it received and had properly elected to claim foreign tax credits under the Treaty for amounts deemed withheld from deemed ACT refunds, Taxpayer's entitlement to foreign tax credits under the Treaty is limited by the Code limitations on those credits, which are expressly incorporated into the Treaty. Taxpayer's characterization of the substitute payments and deemed refunds as dividends for purposes of claiming Treaty benefits and as non-dividends for purposes of applying the Treaty's limitations on foreign tax credits claimed under the Treaty contradicts the plain language of the Treaty, is inconsistent with the legislative history of section 901(k), and violates the fundamental principle that U.S. tax treaties and the Code must be applied consistently whenever possible.

FACTS

Taxpayer, a U.S. corporation, owns all the shares of Subsidiary, a controlled foreign corporation incorporated in the U.K. Both Taxpayer and Subsidiary are engaged in the financial services business.

The requested advice stems from back-to-back securities loans that Taxpayer undertook with Subsidiary during the audit cycle that includes Year 1 through Year 4. As part of that activity, Taxpayer borrowed portfolio interests (*i.e*., less than 10% interests) in the stock of various U.K. corporations and relent the borrowed securities on substantially identical terms to Subsidiary. Subsidiary then held, sold or relent the borrowed securities. Although Subsidiary rarely held the borrowed securities for a significant period of time, it often held the securities when dividends were paid. Taxpayer and Subsidiary borrowed securities pursuant to written securities lending agreements. Those agreements obligated the borrowers (*i.e.*, Taxpayer and Subsidiary) to return the borrowed securities on demand and to remit to the lenders amounts equal to dividends paid during the term of the loan (net of any amounts withheld or similar taxes imposed with respect to the dividend). Therefore, when dividends were paid by the U.K. issuer of borrowed shares, the amount was first paid to Subsidiary, Subsidiary then remitted the same amount to Taxpayer as a substitute payment and, finally, Taxpayer remitted the same amount as a substitute payment to the original lender of the shares. Taxpayer asserts, but has not established, that the U.K issuers paid ACT[2] with respect to dividends paid to Subsidiary. Subsidiary did not pay ACT with respect to the substitute payments it made to Taxpayer either because it was not required to do so under U.K. law or because the dividends underlying the substitute payments were paid after April 5, 1999.

On its federal income tax returns for the years during the audit cycle in which Taxpayer and Subsidiary entered into these security loan transactions, Taxpayer reported income from substitute payments attributable to the loaned securities; deductions representing substitute payments to its lenders; fees involved in the transaction; and foreign tax credits for the amount deemed withheld from ACT refunds deemed received from U.K.

2 For a brief summary of the ACT, see Law and Analysis section below.

Inland Revenue. The total foreign tax credits claimed with respect to the transactions during the audit cycle for Years 1 through 4 were approximately Amount X.[3]

Taxpayer asserts that the substitute payments it received from Subsidiary are treated as dividends for purposes of the Treaty and, therefore, amounts deemed withheld from ACT refunds it was entitled to receive under the Treaty with respect to those payments are eligible for foreign tax credits under section 901. Taxpayer did not file a Form 8833 (Treaty Based Return Position Disclosure under Section 6114 or 7701(b)) with respect to its claims for foreign tax credits.[4] Taxpayer also did not file any claims with the U.K. seeking refunds of the ACT paid with respect to dividends received by Subsidiary that were passed on to Taxpayer in the form of substitute payments during the years at issue. In addition, Taxpayer did not make the election pursuant to Rev. Proc. 2000-13, 2000-1 C.B. 515, to forego the requirement to claim ACT refunds from the U.K. as a condition of claiming foreign tax credits for amounts deemed withheld from deemed ACT refunds attributable to dividends paid after April 5, 1999.

## LAW AND ANALYSIS

Analysis of these foreign tax credit issues requires a basic understanding of the relevant U.K. law and how those rules were reflected in the Treaty. During the years at issue, the U.K. had a partially integrated system of taxation of corporate earnings. During some of those years, a key component of that system was the ACT regime, under which a U.K. corporation was required to pay ACT to the U.K. when it paid a qualifying distribution to its shareholders. The U.K. corporation paying the ACT treated it as an advance payment of a portion of its mainstream corporate income tax. U.K. resident shareholders were entitled to offset their personal tax liabilities with respect to the dividends with a refundable credit for a ratable portion of the ACT paid by the distributing corporation. Thus, the system was designed to eliminate or reduce the shareholder-level taxation of corporate earnings.

Effective for distributions after April 5, 1999, the U.K. repealed the ACT. Notwithstanding the repeal of ACT, a partially integrated system of taxation under U.K. law remained in force because a U.K. shareholder was generally still entitled to a non-refundable tax credit (in the reduced amount of 1/9 of the dividend) upon receipt of a qualifying distribution. Non-resident shareholders, however, were ineligible for any credit in any of the years at issue.

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3 Taxpayer has given conflicting accounts of the years in which it engaged in the security lending transactions and the amounts and years during which it claimed foreign tax credits for taxes withheld from ACT refunds allegedly due with respect to dividends paid on the borrowed securities. Taxpayer originally indicated that some credits were claimed for tax deemed withheld from ACT refunds received with respect to dividends paid during Year 1 and Year 2. Taxpayer recently amended its position and now alleges that all such dividends were paid after April 5, 1999, in Year 3 and Year 4 and that the credits previously identified for earlier years relate to foreign taxes paid on other transactions.

4 The obligation to disclose Treaty-based positions is provided in section 6114 and the failure to disclose such positions is subject to penalties under section 6712.

Under U.K. domestic laws in effect in Years 1 through 4, no withholding tax was imposed on non-resident shareholders with respect to dividends or substitute payments paid to them by U.K. corporations.

In order to equalize the treatment of U.S. and U.K. shareholders, Articles 10 and 23 of the Treaty extended the benefit of the ACT refundable credit to U.S. shareholders who received dividends from U.K. corporations. Under Article 10(2)(a) of the Treaty, U.S. shareholders, in addition to the dividends received from the U.K. corporations, received a refundable tax credit from the U.K. Portfolio investors (*i.e*., less than 10% shareholders) received a refund equal to the entire ACT credit available to shareholders resident in the U.K.; other shareholders received a refund equal to one-half of the ACT paid. With respect to the loaned securities in Years 1 through 4, Subsidiary was a portfolio investor. The Treaty allowed the U.K. to withhold from any ACT refund payable to portfolio investors 15% of the aggregate of the dividend paid by the U.K. corporation and the refund received from the U.K. Article 10(2)(a)(ii) of the Treaty.

By its terms, this Treaty regime applied only as long as U.K. resident shareholders were entitled to a tax credit in respect of dividends paid by a U.K. corporation. *See* Article 10(2) of the Treaty. Accordingly, the regime continued after repeal of the ACT because U.K. residents were still entitled to the 1/9 tax credit.

In cases where shares were borrowed, Taxpayer asserts that U.K. law provided that the lender of the securities, rather than the borrower, was entitled to claim the ACT credit. Although Taxpayer was not the original lender of the borrowed shares, Taxpayer nevertheless claims that the substitute payments it received from Subsidiary were treated as dividends under Article 10 of the Treaty eligible for the ACT refund and that the amount deemed withheld from deemed refunds of ACT in respect of those "dividends" is eligible for the foreign tax credit under section 901.

Issue 1 - Substantiation

Section 905(b) requires taxpayers to establish to the satisfaction of the Secretary the amount of foreign income taxes paid or accrued and "all other information necessary for the verification and computation of such credits." Section 905(b)(1) and (2). Taxpayers may satisfy this burden, in part, by furnishing a receipt from the foreign tax authority showing that the tax was paid. Treas. Reg. §1.905-2(a)(2); *see also* Treas. Reg. §1.901-2(e)(1) (taxpayer must establish the amount of tax that was both owed and actually paid).

Taxpayer's claim for foreign tax credits arises entirely under the Treaty because, as noted above, in Years 1 through 4 U.K. domestic law did not impose tax on dividends or substitute payments paid to nonresident shareholders. Accordingly, under U.K. domestic law, no U.K. tax was actually owed or paid by Taxpayer with respect to the substitute payments it received from Subsidiary. Therefore, Taxpayer's claim rests on a treaty-based return position that it was entitled to ACT refunds and associated foreign tax credits in respect of the substitute payments it received from Subsidiary.

The requirements for substantiating amounts withheld from ACT refunds pursuant to Article 10 of the Treaty varied depending upon when the underlying dividends were paid. For dividends paid prior to April 6, 1999, Rev. Proc. 80-18, 1980-1 C.B. 623, provided that a U.S. shareholder claiming ACT refunds was required to make the claim on the appropriate U.K. form. Rev. Proc. 80-18, Section 3.07. Taxpayers claiming foreign tax credits for amounts withheld from ACT refunds in respect of such dividends could substantiate the amount withheld from the refunds by producing the documentation provided by U.K. tax authorities.

Taxpayer effectively conceded that it is not entitled to any credits with respect to substitute payments received prior to April 6, 1999, by admitting that it never filed claims for or received any refunds from the U.K. from which taxes might have been withheld. Although Taxpayer initially claimed credits in excess of Amount Y in respect of substitute payments received prior to April 6, 1999, Taxpayer belatedly revised its account of the facts to indicate that all of the credits previously claimed for such transactions were attributable to unrelated transactions. That claim has yet to be substantiated by Taxpayer. In addition, although we cannot be certain of the underlying facts, we note that Taxpayer's initial claim of credits for pre-April 6, 1999 payments and its failure to file refund claims for such amounts raises doubts as to whether under U.K. law it was entitled to an ACT refund with respect to the borrowed shares as it asserts.[5] Taxpayer has no basis to claim credits for taxes that might have been, but were not, withheld from refunds it neither applied for, nor received, nor even established it was eligible to receive.

As stated above, effective April 6, 1999, the U.K. repealed the ACT regime, but continued to provide shareholders with reduced credits for corporate-level taxes. For dividends paid on or after April 6, 1999 (and before May 1, 2003[6]), the U.K. resident shareholder credit was reduced from 25% to 1/9 of the dividend. Consequently, U.S. portfolio investors no longer received a net ACT refund payment from the U.K. pursuant to the Treaty because the 15% withholding on the sum of the dividend and ACT refund exceeded the amount of the ACT refund otherwise due under the Treaty. Accordingly, the Service permitted taxpayers to elect out of the generally-applicable substantiation procedures and claim credits up to the amount of the deemed ACT refund without actually filing a refund claim with the U.K. This election was prescribed in Rev. Proc. 2000-13, which required taxpayers to make the election "by so indicating on line 5 of Form 8833 (Treaty-Based Return Position Disclosure Under Section 6614 or 7701(b)) and filing a completed Form 8833 with their income tax return for the relevant year." *Id*.

Taxpayer has indicated that it not only failed to make the election as required on the Form 8833, it never filed that form with respect to these transactions. Accordingly,

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5 *See* n. 10 *infra*.
6 *See* n. 1 *supra*.

Taxpayer remains subject to the generally applicable section 905(b) substantiation standards and must produce documentation from the U.K. authorities that it would have been entitled to the ACT refund and subject to withholding thereon even though it was neither the record owner nor the original lender of the shares on which dividends were paid. Thus, Taxpayer has failed to substantiate its claim for foreign tax credits arising from dividends on the borrowed shares throughout the audit cycle of Years 1 through 4 and, for that reason, all such credits should be disallowed.

Issue 2 – Limitation on Allowable Credits

A. Limitation under the Code

Section 901 permits a taxpayer to claim a credit for income, war profits and excess profits taxes ("income taxes") paid or accrued (or deemed paid) to a foreign country. The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign source income. *See American Chicle Co. v. United States*, 316 U.S. 450, 451 (1942). For purposes of section 901, an income tax is a "compulsory payment pursuant to the authority of the foreign country to levy taxes" and which has the "predominant character of . . . an income tax in the U.S. sense." Treas. Reg. §1.901-2(a)(2).

A taxpayer's ability to claim foreign tax credits is limited by various Code provisions, most of which are intended to preserve the foreign tax credit's purpose of mitigating double-taxation. The limitation that is at issue here is found in section 901(k), under which a taxpayer's ability to claim foreign tax credits is disallowed in two situations where the taxpayer generally would not recognize net income and, therefore, would not be subject to double taxation. *See* General Explanation of Tax Legislation Enacted in 1997, JCS-23-97, at 246 (noting that objectionable transactions "allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits" and comparing holding period requirement for foreign tax credits to similar restrictions under section 246(c)); *cf.* Technical Amendments Act of 1957, H. Rep. No. 775 (holding period requirements adopted in section 246(c) because taxpayers had claimed deductions with respect to dividends paid on shares without recognizing net income). The General Explanation discussion of section 901(k) specifically provides that "[i]t was intended that, in addition to actual dividend payments, the provision apply to additional dividend amounts that are deemed to be paid with respect to the dividend under an applicable U.S. tax treaty." JCS-23-97 ("Blue Book") at 247.

Section 901(k)(1)(A) provides that

> [i]n no event shall a credit be allowed under subsection (a) for any withholding tax on a dividend with respect to stock in a corporation if —
> (i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

> (ii) to the extent that the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Taxpayer argues that section 901(k) does not disallow its foreign tax credits because the substitute payments that it received from Subsidiary and its deemed ACT refunds under the Treaty are not dividends for U.S. tax purposes and section 901(k) applies only to withholding taxes on dividends.[7] We agree that the substitute payments and deemed ACT refunds are not regarded as dividends for U.S. tax purposes under the Code, see section 1058.[8] However, Taxpayer has no basis to claim credits under the Code for amounts deemed withheld from deemed refunds of ACT allegedly due under the Treaty by reason of the substitute payments, because, as discussed above, no tax was actually owed under U.K. law or paid by Taxpayer. If Taxpayer has any colorable claim that it is entitled to foreign tax credits with respect to the substitute payments, that argument necessarily relies on a claim under the Treaty.

<u>Limitation under the Treaty and Code</u>

Article 10(2)(a)(iii) of the Treaty (emphasis added) provided that

> the aggregate of the amount or value of the dividend and the amount of the tax credit . . . paid by the United Kingdom to the United States corporation or other resident (without reduction for the 5 or 15 percent deductions, as the case may be, by the United Kingdom) <u>shall be treated as a dividend for United States tax credit purposes</u>.

Article 10(3) of the Treaty defined the term dividend, if paid by a U.K. corporation, as including "any item which under the law of the United Kingdom is treated as a distribution."[9]

Article 23(1)(b) of the Treaty provided that the amount withheld from the ACT refund under Article 10(2)(a)(i) or (ii) of the Treaty was considered an income tax imposed on the recipient of the dividend. However, Article 23(1) of the Treaty provided that the credits allowed for income taxes paid to the U.K. were "subject

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7 *See* Prop. Treas. Reg. §1.1058-1(d). Section 901(l) does not apply to any withholding taxes imposed with respect to the substitute payments or deemed dividends from ACT refunds at issue because that subsection took effect after the years at issue.

8 As explained below, however, the characterization of the substitute payments under section 1058 does not control under these facts because the Treaty explicitly classifies any such payments that qualify for ACT refunds as well as the associated ACT refund as dividends for purposes of the U.S. foreign tax credit. That language trumps any contrary interpretation under the Code where the taxpayer claims Treaty benefits.

9 The Treaty defines dividends paid by a U.S. corporation as "any item which under the law of the United States is treated as a distribution out of earnings and profits." As noted below, the Taxpayer effectively conceded that its foreign tax credit claim would fail if the U.S. definition of dividend applied in determining its entitlement to ACT refunds net of withholding because substitute payments are not generally treated as dividends under the Code.

to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)."

Taxpayer argues that the substitute payments it received from Subsidiary during the years at issue are dividends under Article 10(2)(a)(iii) and (3) of the Treaty for purposes of allowing it to claim ACT refunds and associated foreign tax credits under the Treaty. However, it relies on section 1058 to characterize those payments as non-dividend payments to avoid disallowance of the foreign tax credits by section 901(k). In other words, Taxpayer asserts that the Treaty's purported characterization of the substitute payments and deemed refunds of ACT as dividends applies to allow it to claim foreign tax credits under the Treaty for amounts deemed withheld from those payments, but is jettisoned for purposes of applying the statutory limitations on the foreign tax credit, such as section 901(k), that the Treaty in Article 23(1) incorporates by reference.

Taxpayer's classification of the substitute payments and refunds of ACT differently for two closely related foreign tax credit purposes fails for several reasons.[10] Taxpayer's position is contrary to the plain language of Article 10 of the Treaty. Article 10(2)(a)(iii) of the Treaty states explicitly and unambiguously that payments that are treated as dividends under Article 10 of the Treaty shall be treated as dividends for U.S. foreign tax credit purposes. Nothing in the Treaty suggests that this language was limited to only those purposes of the credit that favor taxpayers and Taxpayer has not suggested a reasonable basis for such an interpretation.[11] On the contrary, the Treaty drafters (consistent with the U.S. model treaty) were mindful that any entitlement to foreign tax credits must also be subject to U.S. limitations on those credits, including subsequently adopted limits consistent with the general principles of existing law, as provided in Article 23. Therefore, not only does Taxpayer's interpretation run counter to Article 10(2)(a)(iii), it does so in a manner that attempts to circumvent one of the primary purposes of Article 23(1).

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10 This memorandum does not address Taxpayer's threshold contention that the substitute payments with respect to shares in U.K. corporations are dividends within the meaning of Article 10(3) of the Treaty, which turns on whether the payments are treated as distributions under U.K. law. Taxpayer's representative cited U.K. statutes in support of that contention. That such payments are generally taxed as if they were dividends is instructive, but is not necessarily determinative of whether such payments are treated as distributions within the meaning of the Treaty. Moreover, we understand that the U.K. statutes may not apply to certain tax avoidance transactions. Similarly, we express no opinion on whether Taxpayer was the "beneficial owner" of the borrowed securities within the meaning of Article 10(2) of the Treaty. The beneficial owner limitation is intended to exclude from treaty benefits those serving as conduits. Moreover, the commentary to the OECD model treaty provides that "[t]he term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance." Although both of these issues could result in the denial of Taxpayer's rights to claim ACT refunds and associated U.S. foreign tax credits with respect to the borrowed securities, it is unnecessary to resolve them because the Taxpayer's claim fails even if it is assumed that Taxpayer was the beneficial owner of the borrowed shares and the payments it received from Subsidiary were dividends within the meaning of Article 10.

11 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 section 326(2) (1987).

The Treaty's reference to limitations includes the section 901(k) limitations. Although the Treaty was adopted prior to the enactment of section 901(k) in 1997, Article 23(1) of the Treaty provides that entitlement to credits is restricted not only by rules in effect at the time the Treaty was adopted, but also by any subsequently adopted restrictions that are consistent with the general principles of then-existing law. The section 901(k) limitations fall squarely within the fundamental and long-standing principles of the statutory foreign tax credit. Section 901(k) was adopted to prevent taxpayers from claiming credits in two types of situations in which a credit might otherwise be claimed with respect to investments that are unlikely to produce any taxable income – *i.e.*, where they held the investment for very short periods or while obligated to make offsetting payments. In these circumstances, any credits attributable to such transactions are expected to reduce the tax on other income, which is inconsistent with the credit's basic purpose of mitigating double taxation.

Taxpayer's inconsistent classification of the substitute payments and deemed ACT refunds contradicts the principle that U.S. tax treaties and the Code must be applied consistently. Section 894(a) requires that the provisions of the Code be applied with due regard to any treaty obligation of the United States that applies to the taxpayer. The Treaty explicitly provides that a distribution that entitles a U.S. shareholder to benefits under Article 10(2)(a) of the Treaty will be treated as a dividend in the United States for U.S. foreign tax credit purposes. Art. 10(2)(a)(iii) of the Treaty.

In the instant case, Taxpayer asserts inconsistent treatment of the transaction under U.S. domestic law and a tax treaty that itself is part of U.S. law. It is the well-established position of the Internal Revenue Service, as expressed in Rev. Rul. 84-17, 1984-1 C.B. 308, and Rev. Rul. 79-199, 1979-1 C.B. 246, that taxpayers may not "cherry pick" among the provisions of the Code and the income tax treaties to which the United States is a party.[12] Rev. Rul. 84-17 involves a Polish corporation with three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but do not meet the permanent establishment threshold tests of the U.S.-Poland income tax treaty ("Polish Treaty"). Under the Polish Treaty, the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the profits of the two profitable ventures. The ruling concluded that it would thwart the intent of the Polish Treaty if the taxpayer could both invoke the treaty to exclude the profits of the profitable trade or business and invoke the Code to claim the

12 Rev. Rul. 79-199 (taxpayer claiming foreign earned income exclusion under Code could not claim foreign tax credit under treaty for taxes imposed on excluded income) (later codified at section 911(d)(6)). *See also* TAM 200509023 (Nov. 17, 2004) (corporation cannot take inconsistent positions regarding residency); TAM 8524004 (Feb. 12, 1985) (Canadian corporation reporting real property rental income on net basis under section 882(a) of Code could not rely on U.S. -Canada treaty in same year to exempt gain on sale of same real property from U.S. tax).

loss of the loss trade or business against the taxable profit of the permanent establishment. According to the revenue ruling,

> the intent under the Convention . . . would be thwarted if losses not attributable to a permanent establishment could be offset against profits attributable to a permanent establishment. Further, such an offset would require the inconsistent treatment (during a taxable year) of nonattributable gain and loss--such gain being exempt under the Convention and such loss being deductible under the Code.

The holding of Rev. Rul. 84-17 is not inconsistent with the principle--reflected in Article 5(2) of the Polish Treaty-- that a tax treaty should not increase the tax burden on residents of the contracting states, because a taxpayer can always elect to apply the statutory rules as if the treaty had not come into effect. Thus, the ruling concludes that Article 5(2)(a) allows the taxpayer the option to use the provisions of the Code to determine the tax liability with respect to its activities if this results in a lower tax liability than that obtained using the provisions of the Convention with respect to such activities.

A comparable provision found in Article 27(2) of the Treaty provides that the Treaty "shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowances now or hereafter accorded by the laws of either Contracting State." That provision "should be interpreted to prevent the taxpayer from claiming both treaty and Code treatment when the result would defeat the underlying assumptions of the two systems." A.L.I. Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties 82 (1992).

The underlying assumption of Article 10(2)(a) of the Treaty is that the U.S. shareholder has received dividend income with respect to which ACT was paid to the U.K. and should receive a benefit similar to that available to U.K. shareholders under the U.K. integrated tax system. Whether such payments are treated as dividends under the Code is irrelevant. If a term is defined in the Treaty, such definition must prevail for treaty purposes over any contradictory domestic law definition. Only terms not otherwise defined in the Treaty will be defined under the domestic laws of the Contracting State imposing the taxes which are the subject of the Treaty. *See* Article 3(2) of the Treaty. Taxpayer would thwart the underlying assumption of the Treaty if it could claim that a distribution is not a dividend for purposes of the Code's foreign tax credit limitations and *at the same time* invoke Article 10(2)(a)(iii) of the Treaty to treat the distribution "as a dividend for United States tax credit purposes" in order to give rise to a foreign tax credit in the U.S. Finally, the legislative history to section 901(k) expressly contemplated that its restriction would apply to amounts treated as dividends under a U.S. tax treaty. General Explanation at 247.

If Taxpayer so wished, it could have relied on the Code to characterize the substitute payments from Subsidiary, but the deemed refund of ACT from which tax is deemed withheld is a fiction created entirely by the Treaty, which explicitly provides for its treatment as a dividend for U.S. tax credit purposes. Having elected to rely on the

Treaty to characterize the payments as dividends giving rise to deemed refunds of ACT and deemed payments of creditable tax, Taxpayer is precluded from disavowing that treatment solely to avoid disallowance of credits under the section 901(k) limitation.

Given that the Treaty's classification of a payment as a dividend is applicable for purposes of Article 23 and section 901(k), it is our opinion that the substitute payments received by Taxpayer and the deemed ACT refunds, to the extent allowable under the Treaty, are described in section 901(k)(1)(A)(ii) (and perhaps also in section 901(k)(1)(A)(i)) and, therefore, the foreign tax credits claimed for taxes deemed withheld from the deemed ACT refunds with respect to such payments are disallowed.

Please call Michael Gilman at (202) 622-3850 if you have any further questions.

By: ______________________________

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