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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JAMES E. KAGY
SPECIAL LITIGATION ASSISTANT CC:LM:MCT:CIN:1

FROM: M. Grace Fleeman
Assistant to the Branch Chief CC:INTL:BR1

SUBJECT:

This Field Service Advice responds to your memorandum dated February 18, 2000, and supplemental memorandum dated March 16, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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TL-N-7092-99

LEGEND

Corporation A	=	
Corporation B	=	
Corporation C	=	
Corporation D	=	
State E	=	
Political Subdivision F	=	
Country G	=	
Month H	=	
Country I	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Date 5	=	
Date 6	=	
Date 7	=	
Date 8	=	
Date 9	=	
Date 10	=	
Date 11	=	
q-percent	=	

r-percent =

$t =

$u =

$v =

$w =

$x =

$y =

$z =

ISSUES

1. To what extent, if any, is Corporation B entitled to benefits under the U.S.-Country I income tax treaty[1] ("Treaty" or "Country I Treaty") in light of the inconsistent treatment claimed for domestic law purposes and the purpose and intent of the Treaty?

2. If it is determined that Corporation B is entitled to an income exclusion under the Treaty, may the Service deny credit for foreign taxes paid and deemed paid by Corporation B on or with respect to the excluded income?

3. Is the transaction an outbound transaction that is itself a taxable event for U.S. Federal tax purposes?

CONCLUSIONS

1. Corporation B is not entitled to benefits under the Treaty. It has not established that it became a resident of Country I within the meaning of the Treaty. Corporation B's actions, in the circumstances of this case, , permitting the Service to invoke the saving clause and tax Corporation B as if the Treaty had not come into effect. Furthermore, the claimed treaty benefits are inconsistent with

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[1] The Convention Between Country I and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, D.C. on

both Corporation B's inclusion on the Corporation A group's consolidated return, and the purpose and intent of the Treaty, and therefore should be disallowed. Finally, the Treaty permits resort to domestic antiabuse doctrines, beyond the literal terms of the Treaty, to deny benefits to avoid abuse of the Treaty. As a result, Corporation B is not entitled to any Treaty exclusion in Year 3 for the dividend it received from Corporation C or for its subpart F income.

2. If Corporation B is entitled to an income exclusion under the Treaty, credit for foreign taxes paid and deemed paid by Corporation B on or with respect to the excluded income may be denied under domestic law.

3. The extent to which we may treat the transaction itself as a taxable event will turn on our ability to establish that the transaction was in substance an outbound transaction. The specific consequences depend on whether the transaction results in a single corporation that may claim benefits as a resident of Country I, or whether the transaction results in the creation of two separate corporations. If Corporation B is considered to have converted from a domestic to a foreign corporation by reason of the transaction, it should not be included in the parent's consolidated return. The dividend distributed to its parent in Year 4 is includible in income in that year. In addition, the amount of the investment in earnings in United States property determined under section 956(a) as a result of the notes between Corporation B and Corporation A will be included in the income of Corporation A under section 951(a)(1)(B) to the extent not paid out of previously taxed income, with no dividends received deduction. If the transaction is determined to have resulted in the creation of a second corporate entity, and if assets were transferred, the transaction has effected a taxable event. No nonrecognition provision has been shown to apply.

FACTS

Corporation A is a domestic corporation, and the common parent of an affiliated group of corporations filing consolidated Federal income tax returns on a calendar year basis. The Corporation A group is currently under examination for Year 2 and Year 3. Corporation B, which was incorporated in State E in Year 1, is a wholly owned subsidiary of Corporation A that serves as a holding company for the majority of the Corporation A group's controlled foreign corporations.

Corporation C, which is incorporated in Country G, is a wholly owned subsidiary of Corporation B. Corporation C serves as a holding company for the Corporation A group's European operations. In Year 3, there was a decision to repatriate $z of Corporation C's accumulated earnings and profits to the United States parent to enable the United States parent to meet its debt service requirements and to fund its domestic operations. To avoid substantial tax liability upon the repatriation of such a large sum of income that had not been previously taxed, a plan was devised and implemented to

. Corporation C then distributed $z in the form of a dividend to Corporation B, which in turn made the funds available to Corporation A through a series of subsequent loans and payments in redemption of its stock.

1. The transaction

On Date 5, Corporation B's board of directors held a special meeting for the purpose of approving a

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Corporation A stated to the examination team that the purpose behind Corporation B's was to enable it to receive the dividend from Corporation C tax free. The minutes of the special meeting state that following the transaction the corporation would

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On Date 5, Corporation B applied for in Political Subdivision F, Corporation B into Political Subdivision F. The next day, Political Subdivision F effective the same day. Thus, under the laws of Political Subdivision F, Corporation B became, and remains, a Political Subdivision F limited company with all attendant rights and powers.

On Date 5, Corporation B filed under the amended State E law. Pursuant to the

. Its only known remaining tie to the United States is its State E charter. Although the Corporation A group's position is that Corporation B retained its status as a domestic corporation, Corporation B filed a protective gain recognition agreement under section 367(a).

Corporation B's board of directors also completed various steps necessary to comply with provisions of the law of Political Subdivision F, such as amendments to Corporation B's certificate of incorporation, the appointment of a registered agent and registered office in Political Subdivision F, and the appointment of an accounting firm to conduct a statutory audit. Corporation B, which had no employees either prior to or subsequent to the transaction, appointed Corporation D, a pre-existing Country I subsidiary of Corporation A, to perform financial, corporate and other services on behalf of Corporation B.

2. <u>The repatriation</u>

Shortly after the , Corporation C made a dividend distribution of $z, paid to Corporation B in four separate installments on Dates 8 through 11, Year 3. The sum of $y was withheld by Country G on the dividend distribution. Thus, the net dividend received by Corporation B was $x. The withholding tax was based on the q-percent rate provided by the then-applicable U.S.-Country G income tax treaty, rather than the r-percent rate provided by the then-applicable Country I-Country G income tax treaty.

Corporation B immediately loaned $w of the net dividend to Corporation A via three demand promissory notes, paying interest at 30-day LIBOR plus 12.5 basis points. The remainder of the net cash dividend from Corporation C to Corporation B, totaling $v, was immediately loaned by Corporation B back to Corporation C via a demand promissory note dated Date 10, Year 3, paying interest at the then-applicable commercial paper rate.

Corporation B then transferred its rights under the loan with Corporation C, totaling $v, to Corporation A in exchange for a demand promissory note from Corporation A to Corporation B for the then-Country I dollar equivalent and paying interest at 30-day LIBOR plus 12.5 basis points.

In Month H, Year 4, Corporation B transferred Corporation A's outstanding notes to Corporation A in exchange for a portion of Corporation A's shares in Corporation B. The overall effect of this redemption was dividend treatment under U.S. domestic law. We understand that the Corporation A group took the position that

Corporation B is an includible corporation, and therefore a member of the Corporation A group. We further understand that Corporation A also took the position that the dividend was an intercompany distribution that was not subject to U.S. taxation.

3. The tax return

The Corporation A group filed a consolidated federal income tax return for the Year 3 calendar year that included Corporation B as a member for the period before and after the transaction. Although Corporation B changed its fiscal year to end on Date 7, we understand that such change was effective for Country I tax and financial reporting purposes only. For purposes of calculating consolidated taxable income, Corporation B's separate taxable income was reported on a calendar year basis by applying adjusted entries to Corporation B's fiscal year income.

Schedule C of the consolidated return included the $z dividend distribution from Corporation C to Corporation B. Schedule C also included deemed distributions under subpart F of $t attributable to Corporation B's controlled foreign corporations and a section 78 gross up of $u. However, an offsetting exclusion based on treaty benefits was claimed, based on the claim by Corporation B that it is a Country I resident within the meaning of the Treaty.

The Corporation A group claimed a foreign tax credit under section 901 for the Country G withholding tax of $y on the $z dividend from Corporation C. The Corporation A group also claimed a foreign tax credit of $u under sections 902 and 960 for foreign taxes deemed paid by Corporation B with respect to the dividend and subpart F income.

The Corporation A group took the position that it was still entitled to the foreign tax credits because the Treaty is silent as to the treatment of credits linked to income that is taxable only by Country I.

Under Country I's , the dividend that Corporation B received from Corporation C was exempt from Country I income tax. We understand that the applies only . In this case, the relevant treaty was the Country I-Country G income tax treaty.

In addition, we understand that only a portion of Corporation B's income that was treated as subpart F income in the United States was included on the Country I return, because Country I's anti-deferral regime does not impose tax to the same extent as the U.S. subpart F regime. The result is that no tax was paid in the United States, very little tax was paid in Country I, and foreign tax credits were claimed in the United States for foreign taxes paid or deemed paid on or with respect to income that was excluded from the U.S. tax base.

LAW AND ANALYSIS

I. CORPORATION B IS NOT ENTITLED TO THE CLAIMED TREATY BENEFITS

Corporation B states that it continued to be classified as a domestic corporation under section 7701(a)(4) after , for all Code purposes. If so, it remains subject to U.S. federal income tax on its worldwide income. We also understand that Corporation B claims it became a Country I corporation under Country I law and is fully liable to tax in Country I. In the absence of the treaty provisions it relied upon, Corporation B would be fully liable to tax under the domestic rules of both the United States and Country I. Thus, the first issue is the extent, if any, to which the Treaty limits the application of the Internal Revenue Code in this case. After briefly reviewing the standards of treaty interpretation, relevant treaty provisions and technical explanations or other history of the provisions, we then consider their application to the facts.

A. Summary of 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 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, Inc., 499 U.S. at 534; Sumitomo Shoji America, Inc., 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 the taxpayer's position are the residency rules of Article , Article , the miscellaneous rules and saving clause of Article , and the Limitation on Benefits provisions of Article .

1. Provisions Relied Upon by the Taxpayer

a. The Residency Rules

Article of the Country I Treaty defines the term “resident,” stating in paragraph that, “[f]or purposes of this Convention, the term ‘resident’ of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature.” The Technical Explanation prepared by the Treasury Department in states that “[t]he phrase ‘any other criterion of a similar nature’ includes, for U.S. purposes, an election under the Code to be treated as a U.S. resident.” Thus, a corporation is a resident of the United States under paragraph if either (i) it is incorporated in the United States <u>or</u> (ii) it elects under the Code to be treated as a U.S. resident.

The Technical Explanation released by the Treasury Department on , stated in relevant part:

Thus, under the , if a company qualified as a resident of both Country I 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 the other country. As a result of , a company that retains a place of incorporation in the United States and thus remains a resident of the United States under Article of the Treaty, may be treated as a resident of Country I under the .

b. Article

Under paragraph of Article ,

Thus, income derived by a resident of Country I from outside the United States is taxable only by Country I, if it is not dealt with in Articles of the Treaty.

2. Other Provisions Relevant to Corporation A's Treaty-based Position

a. Saving Clause and Other Miscellaneous Rules of Article

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 TE explains that

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:

Paragraph of Article provides a number of exceptions to the saving clause that are not relevant here.

b. Limitation on Benefits

The Protocol added a limitation on benefits article to the Treaty in new Article . Paragraphs of Article set forth rules for determining when a Country I resident has a sufficient nexus to Country I to be entitled to benefits in the United States. The TE explains that these rules prevent treaty shopping by limiting the benefits granted by the United States under the Treaty to those persons whose residence in Country I is not motivated by the existence of the Treaty.

Paragraph
:

As explained by the TE,

B. Correct Application of the Treaty Requires Denial of Benefits

1. Corporation B is Not a Resident of Country I Under Article

Under Article , Corporation B became a resident of Country I when it was , but also remained a resident of the United States by reason of its place of incorporation in State E. Because Corporation B was a resident of both countries after the transaction, it is necessary to consider in Article . The effect of the first sentence of that paragraph is generally to cede taxing jurisdiction to the United States as the place in which the entity was originally formed. The income that is at issue in this case did not arise in either of the Contracting States, and is not dealt with in Articles of the Treaty.

The language of the states

Corporation B's claim of treaty benefits rests on its interpretation of the of Article to award taxing jurisdiction of the income at issue here to Country I. As explained below, even if Corporation B's interpretation of Article were accepted, we conclude nonetheless that Corporation B is not entitled to benefits under Article .

2. Corporation B Should Be Treated as Within the Meaning of the Saving Clause

The saving clause allows each country to tax its residents as if the Treaty had not come into effect. In the case of the United States, the saving clause also allows the United States to continue to tax its citizens and companies . Thus, U.S. citizens and companies are subject to U.S. tax on their worldwide income even if they are treated as residents of Country I under Article after application of the .

When Corporation B , it made an to retain its State E charter, thereby retaining its status as a domestic corporation. Corporation B's retention of its State E charter was the basis for its continued inclusion on the Corporation A group's consolidated return for Year 3 and subsequent years. The retention of Corporation B's State E charter and Corporation B's subsequent inclusion on the parent's consolidated return should be treated as . If Corporation B is treated as a resident of Country I for purposes of the Treaty, the Service may invoke the saving clause and tax Corporation B on its worldwide income as if the Treaty has not come into effect.

3. Corporation B May Not Take Inconsistent Positions under the Treaty and the Code

The general rules for implementation of the Treaty found in Article do not permit the Corporation A group to treat Corporation B as a domestic corporation for purposes of the Code (e.g., for purposes of the consolidated return and dividends received deduction) and simultaneously treat Corporation B as a foreign corporation for purposes of the Treaty. As the following portion of the TE makes clear, 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. 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 (1961); Restatement (3rd) of Foreign Relations Law § 326(2) (1987).

Corporation B is entitled to claim benefits under the Treaty as a resident of Country I. Corporation B also is entitled to apply the Code and to join the Corporation A group consolidated return if that produces a more favorable result than applying the Treaty. However, Article does not permit Corporation B to apply the Code rules and Treaty rules in combination to reach a result that is more favorable than the result under the Code or the Treaty individually. The latter is precisely what occurred. By simultaneously claiming Treaty benefits as a resident of Country I and Code benefits as a resident of the United States, Corporation B asserted that it could (i) join the consolidated return as a domestic corporation, (ii) include the Country G dividend income and therefore claim U.S. foreign tax credits with regard to that income, but nevertheless (iii) claim an exemption from U.S. tax for its Country G dividend.

Corporation B's position under the Code is inconsistent with the structure and underlying assumptions of the Treaty. After application of Article , a taxpayer that would be considered a resident of both the United States and Country I under each country's domestic law is a resident of, and subject to full tax liability in, either the United States or Country I, but not both. Under Article , a taxpayer's "other income" from third countries, such as Country G, is taxable only in the country in which the taxpayer is subject to full tax liability after application of Article . As explained by the Senate Foreign Relations Committee when the Treaty was approved, Article

. Conversely, Article gives

Country I the sole right to tax income sourced in a third country and paid to a resident of Country I.

To the extent that the language of the treaty is not clear, it is also appropriate to refer to the OECD Model and official commentary to discern the views of OECD Member countries in interpreting language similar to that found in the Treaty. Taisei Fire and Marine Insurance Co. v. Commissioner, 104 T.C. 535 (1995). Paragraph 3 of the Commentary to Article 21 (Other Income) of the OECD Model Tax Convention on Income and Capital explains that:

> when income arises in a third State and the recipient of this income is considered as a resident by both Contracting States under their domestic law, the application of Article 4 will result in the recipient being treated as a resident of one Contracting State only and being liable to comprehensive taxation ("full tax liability") in that State only. In this case, the other Contracting State may not impose tax on the income arising from the third State, even if the recipient is not taxed by the State of which he is considered a resident under Article 4.

Because Corporation B has chosen to apply the Code and to join the Corporation A group's consolidated return as a domestic corporation that is liable to U.S. tax on its worldwide income, Corporation B should not be allowed simultaneously to obtain benefits under the Treaty that are not available to a corporation that is fully liable to tax in the United States. Cf. Burke Concrete Accessories v. Commissioner, 56 T.C. 588 (1971) (despite former section 1504(b)(4), possessions corporation could join consolidated return, but only if it did not simultaneously obtain benefits under section 931), acq. 1973-2 C.B. 1; Elastic Fabrics of Puerto Rico v. Commissioner, T.C. Memo 1987-17, 52 T.C.M. (CCH) 1340, 1343 ("by joining the consolidated returns, petitioner waives any section 931 benefits to which it would otherwise be entitled"), acq. AOD CC-1987-007. Corporation B's inclusion on the consolidated return for Year 3 and subsequent years should be treated as a waiver of any benefits to which Corporation B would have been entitled under Article .

4. The Limitation of Benefits Article and Anti-abuse Principles of Domestic Law Require Denial of Benefits That Conflict with the Purpose and Intent of the Treaty

As explained in the TE, there was an express intent when Article (Limitation on Benefits) was added to the Treaty to limit entitlement to the benefits granted by the United States to those persons whose residence in Country I is not considered to have been motivated by the existence of the Treaty. Corporation A has admitted that Corporation B's residence in Country I was motivated solely by the existence of the Treaty. If Corporation B does not satisfy the LOB requirements, it is not entitled to any benefits under the Treaty. Although we assume Corporation B satisfies the LOB requirements in paragraphs of Article , we recommend that this be confirmed. This would require confirmation that Corporation B satisfies the so-called “base erosion” test in Article .

Paragraph of Article confirms that Country I and the United States may each

. To allow Corporation A to apply the Treaty to exclude Corporation B’s non-U.S. source income from the consolidated return, 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 provisions of the Treaty. Therefore, it is appropriate to apply domestic law to prevent the abuse.
The judicial doctrine of substance over form is a principle of domestic law specifically applicable to thwart abusive transactions such as that in this case. Courts typically focus on two factors in determining whether to respect any or all aspects of a taxpayer’s chosen form or transaction: (1) whether there was a non-tax business purpose (a subjective analysis), and (2) whether the transaction had economic substance beyond the production of tax benefits (an objective analysis). <u>See</u> <u>ACM Partnership v. Commissioner</u>, 157 F.3d 231, 247 (3d Cir. 1998), <u>cert. denied</u>, 526 U.S. 1017 (1999); <u>Sochin v. Commissioner</u>, 843 F.2d 351, 354 (9th Cir. 1988), <u>cert. denied</u>, 488 U.S. 824 (1988); <u>Rice’s Toyota World, Inc. v. Commissioner</u>, 752 F.2d 89, 91-92 (4th Cir. 1985). From the taxpayer's own admission, there was no business purpose or profit motive for the interposition of the in the repatriation transaction. Accordingly, the transaction may be recast in accordance with its substance, i.e., a taxable dividend to a United States shareholder from its controlled foreign corporation (“CFC”) of previously untaxed income. Alternatively, the dividend could be treated as being paid to Corporation B before the transaction.

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. <u>Bob Jones University v. United States</u>, 461 U.S. 574, 586 (1982); <u>Brown v. Duchesne</u>, 19 How. 183, 194 (1857); <u>Albertson’s v. Commissioner</u>, 42 F.3d 537, 541 (9th Cir. 1994), <u>cert. denied</u>, 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 intent of the treaty. For example, the Fifth Circuit held in <u>Johansson v. United States</u>, 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 that 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).

The practical reason for the benefits granted in Article is to avoid double taxation. If Corporation B is treated as a resident of Country I under Article , its Country G dividend and subpart F income will be taxable only by Country I, pursuant to Article . Based on the assumption that a taxpayer will be a resident of only one country or the other, Article assigns the exclusive right to tax third-country income that is not dealt with in Articles to the country in which the taxpayer is resident. However, there is an implicit assumption that Corporation B is not also subject to full taxing jurisdiction of the United States. If, as is the case here, Corporation B remains a domestic corporation that is taxable on its worldwide income, and entitled to the benefits of inclusion in the consolidated group, that built-in assumption is not present. Therefore, the Service should look beyond the literal terms of the Treaty and conclude that even if Corporation B is treated as a resident of Country I for purposes of the Treaty, the benefits claimed under Article should be disallowed. That Article was never intended to provide benefits under the particular facts and circumstances of this case. The saving clause of paragraph of Article further supports the conclusion that the United States retains jurisdiction to tax such a company.

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II. IF CORPORATION B IS ENTITLED TO AN INCOME EXCLUSION UNDER THE TREATY, THE FOREIGN TAX CREDITS MUST BE DISALLOWED UNDER DOMESTIC LAW

If it is determined that Corporation B may simultaneously be treated as a domestic corporation that is includible on the Corporation A group's consolidated return and as a nonresident corporation that is entitled under the Treaty to exclude its foreign source income from the group's consolidated taxable income, we believe that credit for foreign taxes paid and deemed paid by Corporation B 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 Corporation B from the Corporation A group's 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 these two years was derived from sources outside the United States *[emphasis added]*.

205 F. 2d at 342. Because the taxpayer's nonresident status precluded the United States from taxing her prior years' income, 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., A.O.D. 1981-31, Helvering v. Campbell & Helvering v. Nell, 139 F. 2d 865 (4th Cir. 1944), I.B. Dexter v. Commissioner, 47 B.T.A. 285 (1942), acq., 1948-2 C.B. 1, and Brace v. Commissioner, 11 T.C.M. 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 Corporation A group succeeds in its argument that the United States has no jurisdiction to tax Corporation B's foreign source income by virtue of its 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 I the jurisdiction to tax Corporation B on its foreign source income by treating it as a nonresident, then under Marsman Corporation B may not claim credit for foreign taxes paid or accrued, or deemed paid or accrued, during periods when Corporation B claims nonresident status.

III. THE TRANSACTION EFFECTED AN OUTBOUND TRANSACTION, WHICH MAY HAVE RESULTED IN A TAXABLE EVENT

The may itself be a realization event, in one of two ways. First, if Corporation B remains a single corporation after the transaction and succeeds in establishing its status as a resident of Country I under the Treaty, then Corporation B should be treated as having become a foreign corporation for Code purposes as well. Corporation B's transformation from a domestic corporation into a foreign corporation may constitute a taxable transaction to both Corporation A and Corporation B, unless a nonrecognition provision applies. Alternatively, if the transaction resulted in the creation of two separate corporations, and assets are actually transferred, the asset transfer is taxable unless a nonrecognition provision applies. Regardless of whether Corporation B is considered to have remained a single corporation or to have become two separate corporations, the Corporation A group's claimed treatment of the transaction is improper.

A. Country I Corporate Resident Status May Result in Taxable Conversion from Domestic to Foreign Status for Code Purposes

Section 7701(a)(4) provides that when used in Title 26, “where not otherwise distinctly expressed or manifestly incompatible with the intent thereof,” the term “domestic” when applied to a corporation means created or organized in the United States or under the law of the United States or of any State *[emphasis added]*. Subject to the same “manifestly incompatible” caveat, section 7701(a)(5) provides that the term “foreign” when applied to a corporation means a corporation that is not domestic. Consequently, before Corporation B
, Corporation B was a domestic corporation because Corporation B was organized solely under State E law. After the transaction, Corporation B possessed both a State E and a Political Subdivision F charter, and thus was organized under both State E and Political Subdivision F law. Despite being organized in two jurisdictions, Corporation A asserts that applying the plain language of section 7701(a)(4), after the transaction Corporation B continued to be a domestic corporation because Corporation B continued to be organized under State E law. As explained above, we believe that continuing to treat Corporation B as a domestic corporation is correct, and that it may be denied the claimed treaty benefits. However, if a court were to conclude that Corporation B is entitled to claim benefits under the Country I Treaty as a resident of Country I, we would be faced with the question of which definition in sections 7701(a)(4) and (5) applies to Corporation B and is compatible with the purposes of Title 26.

The phrase “manifestly incompatible” in section 7701(a) lends authority to the contention that one must depart from the definitions in section 7701(a) where not doing so would have been incompatible with the intent of the Code. See, e.g., Bunnel v. Commissioner, 50 T.C. 837 (1968) (petitioners were the “taxpayers” to whom notice was required within the meaning of sections 6212(a), and 6213(a) and (c), despite the fact that their wholly-owned subchapter S corporation arguably also met the criteria of the definition of “taxpayer” in section 7701(a)(14), which provides that “[t]he term ‘taxpayer’ means any person subject to any internal revenue tax”).

One may argue that it is manifestly incompatible with the intent and purpose of the consolidated return rules under sections 1501-1504 and the accompanying regulations, the dividends received deduction, and the subpart F regime, to treat Corporation B as a domestic corporation if its claim for status as a treaty resident of Country I is successful. Because Title 26 provides that domestic corporations are taxed on their worldwide income while foreign corporations generally pay U.S. tax only on their income effectively connected with a U.S. trade or business and on their U.S. source income, Congress enacted an extensive system of rules to ensure that domestic corporate parents cannot use foreign subsidiaries to defer, or in certain cases entirely avoid, paying a corporate level tax. See, e.g., sections 243-245 (dividends received deduction[3]), section 367(b), and sections 951-964 (subpart F). Under the unique set of facts presented in this case, if Corporation B successfully avoids U.S. tax by claiming benefits under the Treaty as a resident of Country I, its claimed treatment as a domestic corporation for Code purposes should be examined to determine whether such treatment is compatible with the purpose of the applicable Code provision. If not compatible with the statute, the claimed domestic status should be rejected, and Corporation B will be deemed to have converted from a domestic to a foreign corporation. Numerous Code and regulatory provisions establish that the conversion is a realization event[4] at both the corporate and shareholder levels, and that the should be treated as a transfer of assets and liabilities of Corporation B (US) to Corporation B (Foreign) in exchange for Corporation B (Foreign) stock, followed by a distribution by Corporation B (US) of the Corporation (B) (Foreign) stock to its sole owner, Corporation A, in exchange for Corporation A's Corporation B (US) stock. See the discussion below (Part IIIB) regarding whether the conversion may nevertheless qualify for nonrecognition treatment.

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[3]See, e.g., H.R. Rep. No. 72-708, at 12 (1932), which states with respect to section 23(p) of the Revenue Bill of 1932, the predecessor of current section 243, that "[d]ividends received by a corporation are allowed as a deduction in computing the net income of a corporation, upon the theory that a corporate tax has already been paid upon the earnings out of which the dividends are distributed. Where, however, the distributing corporation is exempt from tax, there is no reason why the dividends should be deducted from the gross income of the stockholder corporation."

[4]See, e.g., Code § 953(d)(5) (corporation terminating its section 953(d) election is treated as a domestic corporation transferring all of its property to a foreign corporation in connection with an exchange to which section 354 applies); Treas. Reg. § 1.367(a)-1T(c)(4) (section 367(a) applies to the constructive reorganization and transfer of property from a domestic corporation to a foreign corporation that occurs upon the termination of a section 1504(d) election); Rev. Rul. 89-103, 1989–2 C.B. 65 (deemed conversion of a foreign corporation into a domestic corporation by reason of section 269B(a)(1) treated as a transfer by the foreign corporation of its assets and liabilities to a new domestic corporation in exchange for stock in that domestic corporation, followed by a distribution by the foreign corporation of that stock); Rev. Rul. 88-25, 1988-1 C.B. 116 (conversion of Country Y corporation into a State A corporation under the State A domestication statute treated as a transfer by a foreign corporation of all its assets and liabilities to a new domestic corporation in exchange for stock in that domestic corporation, followed by a liquidating distribution of that domestic corporation stock). Cf. Treas. Reg. § 1.337(d)-4 (taxable corporation's change in status to a tax-exempt entity treated as if the taxable corporation transferred its assets to a tax-exempt entity).

Additionally, Corporation B would be a CFC after the transaction. Corporation A nevertheless avoids any deemed distribution under subpart F from Corporation B in Year 3 because Corporation B would not have been a CFC for an uninterrupted period of 30 days or more during Year 3. See Code § 951(a)(1). Because section 1504(a)(3) excludes foreign corporations from the definition of an includible corporation, Corporation B would no longer be includible on the consolidated return as a member of the Corporation A group, which would only be able to credit foreign taxes paid and deemed paid by Corporation B under sections 902 and 960. Consequently, the Year 4 dividend from Corporation B to Corporation A would not qualify for the exclusion provided by Treas. Reg. § 1.1502-3(f)(2)(ii) for intercompany distributions, and would be subject to U.S. tax, with no offsetting dividends received deduction. In addition, the notes between Corporation B and Corporation A in Year 4 constitute an investment of the CFC's earnings in United States property within the meaning of section 956(a), requiring an inclusion in income of Corporation A under section 951(a)(1)(B) to the extent not paid out of previously taxed income.

B. If the Transaction Resulted in the Existence of Two Separate Taxable Entities, a Taxable Event May Have Occurred

Whether an organization is an entity separate from its owners to be respected for federal tax purposes is a matter of federal tax law, not local law. Treas. Reg. §§ 301.7701-1(a)(1), (3). However, federal tax law requires one to determine as a factual matter the status of the entity under state law, including its rights and obligations. See Treas. Reg. § 301.7701-2. Thus, for federal tax purposes, a corporate entity is generally formed when there is a valid incorporation under state law. See O'Neill v. United States, 410 F.2d 888, 894 (6th Cir. 1969); Knoxville Truck Sales & Service v. Commissioner, 10 T.C. 616, 619-20 (1948), acq. C.B. 1948-23. The leading case for determining whether a corporation is recognized for Federal tax purposes is Moline Properties v. Commissioner, 319 U.S. 436 (1943). Moline stands for the proposition that a corporation is a separate taxable entity "whether the purpose [of its existence] is to gain an advantage under the law of the state of incorporation . . . or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation." Id. at 438-9 (citations omitted).

In the present case, the transaction may have resulted in two separate corporations, one in Country I ["Corp B (Country I)"] and one in State E ["Corp B (US)"]. First, Corporation B was incorporated under the laws of State E in Year 1 and is declared by State E to be a "body corporate" under its laws. Second, pursuant to the transaction, Political Subdivision F issued a corporate charter to Corporation B in Year 3, treating it as a "body corporate and politic" organized under the laws of Political Subdivision F. Further, because Corp B (US) was organized under the laws of State E, it is a domestic corporation. See Code § 7701(a)(4). Similarly, by reason of its organization in Political Subdivision F as a corporate entity with its members having limited liability, Corp B (Country I) would be a foreign corporation. See Code § 7701(a)(5). If these entities are determined to be two corporations, which we need not decide here, there is a taxable asset transfer if assets are determined to have been moved. Indeed, Corporation B itself believed that the transaction may constitute a transfer of assets from a domestic Corporation B to a foreign Corporation B, as evidenced by its filing a section 367(a) gain recognition agreement with respect to the Corporation C stock with its tax return for the tax year ending Date 6, Year 3, the year in which the transaction occurred.

To the extent that Corporation B is considered to have transferred assets and liabilities to Corp B (Country I) in exchange for Corp B (Country I) stock, it realized any gain or loss in the assets transferred, and pursuant to section 1001(c), must recognize that gain and loss, unless a nonrecognition provision applies. Additionally, Corporation A may be considered to have exchanged its Corp B (US) stock for Corp B (Country I) stock, and therefore must recognize any gain or loss it realized on that exchange, unless a nonrecognition provision applies. See Code § 1001(c).

Although section 368(a)(1) lists general categories of transactions that will be treated as tax-free reorganizations, a transaction may qualify as a tax-free reorganization only if the transaction has a valid business purpose. See Gregory v. Helvering, 293 U.S. 465 (1935); Treas. Reg. §§ 1.368-1(b), -1(c), and -2(g). The avoidance of federal income taxes is not a valid business purpose. Wortham Mach. Co. v. United States, 521 F.2d 160, 162 (10th Cir. 1975) (noting that "[c]ommercial transactions 'entered upon for no other motive but to escape taxation'" are excluded from pertinent tax statutes) (citations omitted). To date, the taxpayer has articulated no purpose for the transaction except avoidance of U.S. tax when Corporation C paid dividends to Corporation B. Based on these facts, the transaction could not qualify as a tax-free reorganization because avoidance of U.S. tax is not a valid business purpose.

The precise tax consequences to Corporation B resulting from the transaction will vary depending upon several matters that require further factual development. First, it is important to learn whether the post-transaction assets are owned 100% by Corp B (US), 100% by Corp B (Country I), or jointly by both corporations.[5] Additional information is needed before it can be determined whether the transaction should be treated as a nonrecognition transaction under subchapter C (including,

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[5]Tax treatment differs depending on whether Corp B (Country I) is treated as a separate foreign corporation or recharacterized as a separate domestic corporation pursuant to section 269B. Section 367(a) will apply to a nonrecognition transfer to Corp B (Country I) if it is a foreign corporation.

but not limited to, the application of section 367(a)), or whether it is a taxable transaction. Such facts include (i) the corporate name in which the stock certificates of Corporation C and other subsidiaries are held, (ii) the location and custody of the certificates, (iii) the allocation of benefits and burdens of such ownership or custody, and (iv) whether there were transfers of Corporation B's stock ownership of foreign subsidiaries (in whole or in part) in conjunction with the transaction and if so, how they were effected and by whom. Any non-tax purpose for repatriating the cash and the ultimate disposition of the money must be ascertained.

Likewise, depending upon whether the stock of Corporation C is owned by Corp B (US), Corp B (Country I), or jointly, and whether Corp B (Country I) is treated as a domestic corporation under section 269B, the Federal income tax treatment of the $z dividend from Corporation C will vary. To the extent the dividend is considered paid to Corp B (US), it must be reported on the Corporation A group's Year 3 consolidated return. To the extent the dividend is considered paid to Corp B (Country I), it would be taxable to Corp B (Country I) as a separate domestic corporation, because a stapled entity may not join in the filing of a consolidated return. <u>See</u> Notice 89-94, 1989-2 C.B. 416.

If you have any further questions, please call (202) 622-3880.

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