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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JOHN HAWLEY, Group Manager EG-110/2110
Examination Branch, International District Operations

FROM: W. EDWARD WILLIAMS, Senior Technical Reviewer
Branch 1 (International) CC:INTL:BR.1

SUBJECT:

This Field Service Advice responds to your memorandum dated July 29, 1998. 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.

LEGEND:

Taxpayer =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

ISSUES:

1. Whether the requirement in I.R.C. § 882(c)(2) that a foreign corporation file a return "in the manner prescribed by subtitle F" to get the benefits of deductions and credits authorizes the Secretary to impose a timely filing requirement by regulation.

2. Whether I.R.C. § 882(c)(2), requiring that a return be timely filed by a foreign corporation to obtain the benefits of deductions and credits, conflicts with the allowance of deductions in the Business Profits Article of the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes (hereafter referred to as the United States - Germany Income Tax Convention).

CONCLUSION:

The timely filing requirement in Treas. Reg. § 1.882-4(a)(3) is valid as an interpretive regulation because it "carries out the congressional mandate in a proper manner" and "harmonizes with the plain language of the statute, its origin, and its purpose." *National Muffler Dealers Ass'n. v. United States*, 440 U.S. 472, 476 (1979). I.R.C. § 882 (c)(2) provides that a foreign corporation may claim deductions (or credits) only if it files "a true and accurate return, in the manner prescribed in Subtitle F." The regulations establish the filing deadline by incorporating I.R.C. § 6072, entitled "Time for filing income tax returns." Section 6072 of the Code is contained in Subtitle F. Thus, the regulation's timely filing requirement "harmonizes with the plain language of the statute." *Espinosa v. Commissioner*, 107 T.C. 146 (1996), which involved, *inter alia*, tax years before the effective date of the current regulations, does not lead to the conclusion that Taxpayer is entitled to the deductions claimed on their untimely filed returns for years after the effective date of the regulations. The Tax Court found it unnecessary to opine on the validity of Treas. Reg. § 1.882-4(a)(3). Moreover, the rationale underlying the *Espinosa* opinion supports a disallowance of the claimed deductions and credits.

Treas. Reg. § 1.882-4 does not violate Paragraph 3 of Article VII (Business Profits) of the United States - Germany Income Tax Convention. Treas. Reg. § 1.882-4 is a part of the administrative and procedural framework of the United States tax system within which the provisions of the treaty operate. The timeliness requirement concept embodied in Treas. Reg. §1.882-4 was already a part of the United States' tax administration system when the United States - Germany Income Tax Convention was negotiated and entered into force, and the regulation merely provides Taxpayers with a bright-line application of this concept. Treaties are entered into with the underlying understanding that the provisions of the treaties are subject to the administrative and procedural framework needed for proper administration of each contracting state's tax system.

FACTS:

The Taxpayer is a German corporation which manufactures machinery in Germany, and installs it for customers around the world. Because the installation process is complex, the Taxpayer sends its personnel to the United States and other countries for extended periods of time to receive the equipment and complete the installation and testing.

The Taxpayer did not file tax returns for Year 1, Year 2, Year 3, Year 4, and Year 5. The Taxpayer's new certified public accountants reviewed the arrangement and advised the Taxpayer that due to the extended nature of the presence of Taxpayer's employees in the United States, the company was required to file income tax returns. They further advised the Taxpayer to file Forms 1120F for Year 1 through Year 5. The Taxpayer came forward to the Internal Revenue Service voluntarily, and has committed to file and pay the proper amount of tax for the years in question, regardless of the Service's decision with respect to the deductibility of expenses. More than 18 months have passed since the due dates for the returns for the years in question. The Service has not yet filed I.R.C. § 6020(b) returns on the Taxpayer's behalf.

Although Treas. Reg. § 1.882-4(a)(3) provides that foreign corporations will be allowed to claim deductions "only if a return for that taxable year is filed by the foreign corporation on a timely basis," the Taxpayer has asked for a waiver of this requirement and allowance of deductions and credits for the following reasons:

1. Relying on *Espinosa* and the statutory language of I.R.C. § 871(d)(3), I.R.C. § 882(c) provides that a foreign corporation shall receive the benefit of deductions and credits only if a return is filed "in a manner prescribed by subtitle F, and the "manner" of filing a return does not include a timeliness requirement;
2. The Taxpayer is entitled to claim deductions under Article 7(3) of the United States-Germany Income Tax Convention;
3. Alternatively, the Taxpayer asked to be allowed the deductions "based on general principles of equity" because it voluntarily disclosed to the Service its failure to file.

LAW AND ANALYSIS

ISSUE 1

Taxpayer argues that the requirement that a Taxpayer file a return "in the manner prescribed in subtitle F" in I.R.C. § 882(c) does not include the "timeliness" of such filing. To support this argument, Taxpayer points to *Espinosa,* in which the

Tax Court correctly noted that the reference to “the manner prescribed in Subtitle F” does not explicitly contain a time limit. This issue ultimately turns on whether the timely filing requirement promulgated in Treas. Reg. § 1.882-4(a)(3) is valid.

I.R.C. § 882(c)(2) generally provides that a foreign corporation may claim deductions (and credits) only if it files "a true and accurate return, in the manner prescribed in Subtitle F, including therein all the information which the Secretary may deem necessary for the calculation of such deductions or credits."

Treas. Reg. § 1.882-4(a)(2) provides in part that:

> A foreign corporation shall receive the benefit of the deductions and credits otherwise allowed to it with respect to the income tax, only if it timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed by subtitle F, a true and accurate return of its taxable income which is effectively connected, or treated as effectively connected, for the taxable year with the conduct of a trade or business in the United States by that corporation.

Treas. Reg. § 1.882-4(a)(3) provides that whether a return for a particular taxable year is considered filed on a timely basis will depend on whether the foreign corporation filed a return for the immediately preceding taxable year-

A. If a return was filed for the immediately preceding taxable year, or if the taxable year in question is the first taxable year for which a return is required to be filed, then the return must be filed within 18 months of the due date set forth in I.R.C. § 6072 and the underlying regulations.

B. If no return was filed for the immediately preceding taxable year, and the taxable year in question is not the first taxable year for which a return is required to be filed, then the return must be filed no later than the *earlier* of (i) 18 months of the due date set forth in I.R.C. § 6072 or (ii) the date the IRS mails a notice to the foreign corporation advising the corporation that the tax return has not been filed and that no deductions or credits (with a few exceptions not relevant here) may be claimed by the Taxpayer.

Treas. Reg. § 1.882-4 was proposed in its present form in July 1989 and was adopted in December 1990. The prior version of Treas. Reg. § 1.882-4 did not have an express provision conditioning the allowance of deductions to a foreign corporation on the filing of a timely return. The preamble to current Treas. Reg. §1.882-4 states:

> Commentators questioned the validity of the filing deadlines as set forth in the proposed regulations. The filing deadlines were not eliminated in the final regulations, however, since the statute clearly provides for the denial of deductions and credits if returns are not filed in a timely manner. This requirement is justified because of the different administrative and compliance concerns with regard to nonresident alien individuals and foreign corporations.

T.D. 8322, 1990-2 C.B. 172.

In determining the degree of deference accorded to regulations promulgated by administrative agencies, courts traditionally have distinguished between regulations that are "legislative," and those that are "interpretative." Legislative regulations are those issued pursuant to a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision. *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981); *Batterton v. Francis*, 432 U.S. 416, 425 (1977). Legislative regulations "are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *E.I. du Pont de Nemours v. Commissioner,* 41 F.3d 130, 135 (3rd Cir. 1994), *aff'g* 102 T.C. 1 (1994), *quoting Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984). By contrast, interpretative regulations are issued under the general grant of authority found in I.R.C. § 7805(a), which empowers the Secretary to adopt all "needful rules and regulations" for the enforcement of the internal revenue laws. *E.I. du Pont de Nemours* 41 F.3d at 135. The Commissioner's interpretations set forth in the regulations can be measured against a specific provision of the Code, and thus are given less deference than a legislative regulation. *Rowan Cos*; *E.I. du Pont de Nemours* ("[i]n the tax area, we are still required to treat regulations issued under a general grant of authority with broad deference, although to a somewhat lesser degree than when Congress has made a specific delegation of authority in a specific statute"). In this regard, an interpretative regulation will pass muster if it "carries out the congressional mandate in a proper manner" and "harmonizes with the plain language of the statute, its origin, and its purpose." *National Muffler Dealers Ass'n. v. United States*, 440 U.S. 472, 476 (1979). The regulation must be sustained unless unreasonable and plainly inconsistent with the revenue statutes; it should not be overruled except for weighty reasons. *Bingler v. Johnson*, 394 U.S. 741, 750 (1969); *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). *See also, United States v. Correll*, 389 U.S. 299, 307 (1967); *Rowan Cos.; New Jersey v. Department of Health and Human Services*, 670 F.2d 1262, 1282-83 (3d Cir. 1981); *Pacific First Federal Savings Bank v. Commissioner,* 961 F.2d 800, 803-804 (9th Cir. 1992). The deference given to interpretative regulations by the courts is a reflection of the principle that "Congress has delegated to the Secretary of the Treasury, not to [the courts], the task of, administering the tax laws of the Nation."' *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981), *quoting United States v. Cartwright*, 411 U.S. 546, 550 (1973). For a recent Tax Court opinion discussing the standard of review applicable to legislative and interpretative regulations, *see Central Pennsylvania Savings Association and Subsidiaries v. Commissioner*, 104 T.C. 384 (1995).

In this case, the timely filing requirement set forth in Treas. Reg. § 1.882-4(a)(3) is an interpretive regulation because it was not issued pursuant to a specific grant of authority but under the general grant of authority found in I.R.C. § 7805(a). The timeliness requirement in Treas. Reg. § 1.882-4(a)(3) is valid as an interpretive regulation because it "carries out the congressional mandate in a proper manner" and "harmonizes with the plain language of the statute, its origin, and its purpose." *National Muffler Dealers Ass'n.,* 440 U.S. at 477.

I.R.C. § 882(c)(2) provides that a foreign corporation may claim deductions (and credits) only if it files "a true and accurate return, in the manner prescribed in Subtitle F." The regulations establish the filing deadline by incorporating I.R.C. § 6072, entitled "Time for filing income tax returns." Section 6072 of the Code is contained in Subtitle F. Thus, the regulation's timeliness requirement "harmonizes with the plain language of the statute." *National Muffler Dealers Ass'n.,* 440 U.S. at 477.

Moreover, the timeliness requirement in the regulation "carries out the congressional mandate in a proper manner consistent with its origin and purpose." Courts consistently found that, with respect to section 233 of the 1939 Code (the predecessor to current section 882(c)(2)), there is a "terminal point" after which a taxpayer can no longer claim the benefit of deductions by filing a return. *Blenheim Co., Ltd. v. Commissioner*, 125 F.2d 906 (4th Cir. 1942), *aff'g* 42 B.T.A. 1248 (1940). *Taylor Securities, Inc. v. Commissioner, 40 B.T.A. 696 (1939).* In *Blenheim Co.,* the court stated:

> This terminal date, which the Board of Tax Appeals first adopted in Taylor *Securities v. Commissioner*, 1939, 40 B.T.A. 696, is directed against those foreign corporations which instead of being induced voluntarily to advise the Commissioner of their domestic operations, might find their interests best served by filing no return whatever, and then waiting until such time, if any, as the Commissioner discovers their existence and acquires sufficient information about their income on which to base a return. Unless they are precluded from then obtaining the deductions and credits under such circumstances, such foreign corporations can, if detected, come in for the first time after the

> Commissioner has made a return and suffer no economic loss other than the general 25% late filing penalty which applies to domestic as well as foreign corporations.

Id. at 190.

The court further observed that the fact that Congress intended for the condition in Section 233 to be strictly applied is apparent from the use of the limitation "only." The court noted:

> The difficulty here encountered by the Commissioner in attempting to ascertain the petitioner's correct income tax is a striking example of the many administrative problems inherent in the application of the federal income tax to foreign corporations. This has prompted Congress to impose special conditions on such corporations. Indeed, unless a foreign corporation is induced voluntarily to advise the Commissioner of all of its income attributable to sources within the United States and of the exact nature of all deductions from such income, the Commissioner may never learn even of the corporation's existence, and, in any event, he will probably be unable to determine the correct amount of its taxable income. ... The situation is pregnant with possibilities of tax evasion. In express recognition of this fertile danger to the orderly administration of the income tax as applied to foreign corporations, Congress *conditioned* its grant of deduction on the timely filing of true, proper and complete returns. ... The conclusion that the preparation of a return by the Commissioner a reasonable time after the date it was due terminates the period in which the Taxpayer may enjoy the privilege of receiving deductions by filing its own return, is consistent not only with the intention of Congress as evidenced by the legislative history of Section 233, but also with consideration of sound administrative procedure.

Id. at 909-10 (Emphasis in the original).

The Taxpayer also points to the fact that I.R.C. § 871(d)(3) provides that an election under I.R.C. § 871(d)(1) to treat real property income as effectively connected income "may be made only in such manner and at such time as the Secretary may by regulations prescribe." Taxpayer argues that if Congress intended a time requirement in I.R.C. § 882, the statute would include language similar to that in I.R.C. § 871(d)(3). We do not believe that the difference in language is determinative. First, I.R.C. § 871(d)(3) is distinguishable as that statute deals with the form and time of an election and revocation. Second, the regulations under that section are legislative rather than interpretive, since as discussed above, a legislative regulation is one in which Congress gives a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision. Finally, whether Treas. Reg. § 1.882(c)(2) is valid is determined by whether it meets the test for interpretive regulations, *i.e.*, the regulation's timeliness requirement "harmonizes with the plain language of the statute."

The issue in *Espinosa* was whether the untimely returns filed by a non-resident alien individual, after the Commissioner notified the Taxpayer that substitute returns had been prepared but before a statutory notice of deficiency was issued, were sufficient to avoid the disallowance of deductions under I.R.C. § 874(a). The Tax Court in *Espinosa* rejected the petitioner's argument that it could avoid the effect of I.R.C. § 874(a) by filing returns prior to issuance of a statutory notice of deficiency for years prior to the effective date of Treas. Reg. §1.874-1(b)(1) (years 1987 through 1989). The Tax Court concluded that where the petitioner did not respond to the Commissioner's letters dated November 13, 1992, January 12 and February 3, 1993, and waited seven months to file returns after the letter dated March 23, 1993, the Taxpayer could not avoid the disallowance of deductions under section 874 (a). 107 T.C. at 156-158. The *Espinosa* court stated:

> [W]hile sections 874 (a) and 882(c)(2) contain no explicit time limit, the policy behind these provisions, as applied by the case law, dictates that there is a cut-off point or terminal date after which it is too late to submit a tax return and claim the benefit of deductions. *If no cut-off point existed, Taxpayers would have an indefinite time to file a return, and these provisions would be rendered meaningless.* [Emphasis added.]

Id. at 157.

The *Espinosa* court further stated that to hold otherwise would render the entire provisions of the statute a nullity. *Id.*, *citing Gladstone Co. v. Commissioner*, 35 B.T.A. 764, 768 (1937)). With respect to tax years 1990 and 1991, the Tax Court in *Espinosa* found it unnecessary to address the petitioner's argument that Treas. Reg. § 1.874-1(b) was invalid. Instead, the Tax Court upheld the Commissioner's disallowance of deductions based on I.R.C. § 874 and the existing case law.

Accordingly, since the facts in *Espinosa* are distinguishable and the court refused to address the validity of Treas. Reg. § 1.882-4(a)(3), *Espinosa* is not dispositive and does not lead to the conclusion that Taxpayer is entitled to the deductions claimed on its untimely filed returns. Moreover, the rationale underlying the *Espinosa* opinion supports a disallowance of the claimed deductions and credits.

ISSUE 2

The Taxpayer argues that Paragraph 3 of Article VII (Business Profits) of the United States - Germany Income Tax Convention entitles it to deductions and that the treaty contains no requirement for the filing of a timely return. On this point, the Taxpayer argues that the treaty is not in conflict with I.R.C. § 882 because in its view, I.R.C. § 882 also contains no explicit time requirement. Thus, in essence, Taxpayer argues that Treas. Reg. § 1.882-4 violates the treaty. We disagree.

Treas. Reg. § 1.882-4 is a part of the administrative and procedural framework of the United States tax system within which the provisions of the treaty operate. The timeliness requirement concept embodied in the regulation was already a part of the United States' tax administration system when the United States - Germany Income Tax Convention was negotiated, and the regulation merely provides Taxpayers with a bright-line application of this concept. Treaties are entered into with the underlying understanding that the provisions of the treaties are subject to the administrative and procedural framework needed for proper administration of each contracting state's tax system.

Paragraph 3 of Article VII (Business Profits) of the United States - Germany Income Tax Convention provides:

> In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including research and development expenses, interest, and other similar expenses and a reasonable amount of executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere.

The Treasury Department Technical Explanation to Paragraph 3 of Article VII (Business Profits) provides in part:

> Paragraph 3 provides that, in determining business profits of a permanent establishment, deductions shall be allowed for expenses incurred for the purposes of the permanent establishment. Deductions are to be allowed regardless of where the expenses are incurred. The paragraph specifies that among the expenses referred to which are incurred for the purposes of the permanent establishment are

expenses for research and development, interest and other similar expenses. Also included is a reasonable amount of executive and general administrative expenses.

The United States - Germany Income Tax Convention was signed on August 29, 1989, and brought into force on August 21, 1991.

The denial of deductions under Treasury Regulation section 1.882-4(a)(3)(i), pursuant to I.R.C. § 882(c)(2), violates Article VII (Business Profits) of the United States - Germany Income Tax Convention only if application of the regulation to the Taxpayer is inconsistent with the intent of the parties and the purpose of the specific treaty provision. Every attempt should be made to harmonize the application of the treaty with tax legislation. *Estate of Burghardt v. Commissioner*, 80 T.C. 705, 713-716 (1983); *Mundry v. United States*, 11 Cl.Ct. 207, 211-212 (1986). The goal of treaty interpretation is to give the specific words of a treaty a meaning consistent with the genuine shared expectations of the contracting parties. *Maximov v. United States*, 299 F.2d 565, 568 (2d Cir. 1962), *affd.,* 373 U.S. 49 (1963); *see also United States v. Stuart*, 489 U.S. 353 (1989) (the literal terms of a convention must be interpreted consistently with the expectations and intentions of the United States in entering into the income tax convention). In interpreting treaties, courts will first look to the plain meaning of the language of the treaty. *Sumitomo Shoji Am., Inc. v. Avaliano*, 457 U.S. 176, 180 (1982). Where the plain meaning of the language of the treaty is ambiguous or silent on a point, courts will look to extrinsic materials. *See Tseng v. El Al Israel Airlines, Ltd.*, 122 F.3d 99 (2d. Cir. 1997) ("Treaties are construed more liberally than private agreements, and to ascertain their meaning we may look beyond the written words to the history of the treaty, the negotiations, and the practical construction adopted by the parties," *citing Choctaw Nation of Indians v. United States*, 318 U.S. 423, 431-32 (1943); *see also* Vienna Convention on the Law of Treaties art. 32, U.N. Doc. A/CONF. 39/27 (1969), *reprinted in* 63 Am. J. Int'l L. 875, 885 (1969) (it is appropriate to use supplementary materials to "confirm the meaning resulting from" a contextual reading of the treaty's plain language)).

The role of the Business Profits Article is to ensure the proper allocation of the profits of a resident of a contracting state between its country of residence and the other contracting state where the resident does business through a permanent establishment; it is not intended to include administrative provisions such as filing requirements. Section 882(c)(2) and Treas. Reg. § 1.882-4 are not intended to allocate items of income and expenses between Taxpayer’s U.S. permanent establishment and Taxpayer’s German operations. I.R.C. § 882(c)(2), as interpreted by Treas. Reg. § 1.882-4, sets forth a reasonable period of time for foreign corporations to assess whether they are engaged in a trade or business in the United States and to file either a complete return or alternatively, a protective return pursuant to Treas. Reg. § 1.882-4(a)(3)(iv). Nor is the Business Profits Article intended to override administrative provisions under the domestic law of a contracting state that are necessary to ensure tax compliance.

Section 233, the predecessor to I.R.C. § 882(c)(2), dates back to the Revenue Act of 1928. The United States - Germany Income Tax Convention at issue here was brought into force on August 21, 1991. Thus, the United States government's position that a timeliness requirement was implicit in I.R.C. § 882(c)(2), and its predecessor section 233, was well established at the time the United States - Germany Income Tax Convention was negotiated and entered into force. *Taylor Securities, Inc. v. Commissioner*, 40 B.T.A. 696 (1939); *Blenheim Co., Ltd. v. Commissioner*, 125 F.2d 906 (4th Cir. 1942); *Georday Enterprises, Ltd. v. Commissioner*, 126 F.2d 384 (4th Cir. 1942). By 1991, it was also an established principle of U.S. tax law that in order to encourage compliance with, and to facilitate proper administration of, the U.S. tax system vis-a-vis foreign corporations it was necessary to have a terminal point after which deductions would not be allowed, even if a Taxpayer files a true and accurate return after that point. *Taylor Securities, Inc. v. Commissioner*, 40 B.T.A. 696 (1939); *Blenheim Co., Ltd. v. Commissioner,* 125 F.2d 906 (4th Cir. 1942); *Georday Enterprises, Ltd. v. Commissioner*, 126 F.2d 384 (4th Cir. 1942). In addition, the timeliness requirements in the regulations were set forth in the proposed regulations, which were published on July 31, 1989, 1989-2 C.B. 823. The United States - Germany Income Tax Convention was signed on August 29, 1989. Had the parties intended that the regulations not apply to taxpayers covered by the Convention, the expression of that intent would have been made.

One need only peruse the entire Article 7 to conclude that its purpose is to define the general nature of profits to be taxable to a permanent establishment, and the deductions to be allowed. There is no language to suggest that the contracting states intended to address their respective administrative filing requirements. Had it been the intention of the contracting states to override I.R.C. § 882(c)(2), and the regulations thereunder, "it would have been very easy to have declared the purpose in unmistakable terms" when they drafted Article 7 Paragraph 3. Having failed to do so, long-standing rules of construction mandate that there is no implied repeal of I.R.C. § 882(c)(2) or its regulations. *Tennessee Valley Authority v. Hill*, 437 U.S. 153, 189-90 (1978); *Morton v. Mancari*, 417 U.S. 535, 549-51 (1974).

The above analysis is supported by the Commentary to Article 7(1) of the 1977 OECD Model Tax Convention on Income and Capital, which is substantially identical to Article VII Paragraph 1 of the United States - Germany Income Tax Convention. The allocation provisions in the Article are not intended:

> to sanction any such malpractice [*i.e.*, the undisclosed channeling of profits away from a permanent establishment], or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. *It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion*. [Emphasis added.] (Paragraph 1.8).

In addition, the Commentary to Article 7(3) confirms that its purpose is to define the general nature of profits and deductions to be considered in the taxation of a permanent establishment. Paragraph (3) "clarifies, in relation to the expenses of a permanent establishment, the *general directive* laid down in paragraph 2." The entire Commentary to Paragraph 3 gives examples that address the nature of deductions, without reference to administrative methods to combat evasion.

Further, Paragraphs 7 through 10 of the 1977 OECD Commentary to Article 1 address "improper use of the Convention." Paragraph 7 provides that tax conventions should not be used to help tax avoidance or evasion. Paragraph 7 further provides that individual states should adopt laws targeting abusive transactions and should ensure that the language or their bilateral income tax treaties do not nullify these domestic rules. The Commentaries to Article 1 of the 1992 and 1998 OECD Conventions adopt the language of Paragraphs 7 through 10 of the 1977 OECD Commentary to Article 1.

Additionally, the 1992 and 1998 OECD Commentaries to Article 1 provide, in Paragraphs 11 through 26, further Commentary that clarifies the scope of the basic rules of Paragraphs 7 through 10. Paragraph 22 of the OECD Commentaries to Article 1 provides that different forms of tax treaty abuse were considered along with possible ways to deal with them such as "substance-over-form" rules and "subpart F type" provisions. Paragraph 23 specifically provides, in part:

> The large majority of OECD Member countries consider that such measures are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. *These rules are not addressed in tax treaties and are therefore not affected by them.* (Emphasis added.)

Furthermore, Paragraph 24 provides that "it is the view of the wide majority that such rules, and the underlying principles, *do not have to be confirmed in the text of the convention to be applicable.*" (Emphasis added.)

Paragraphs 23 and 24 of the 1992 and 1998 OECD Commentaries to Article 1 are instructive regarding the proper interaction of general anti-abuse rules and the United States - Germany Income Tax Convention. The principles adopted by these OECD Commentaries, which reflect the views of the wide majority of OECD member countries, clearly indicate that domestic anti-abuse principles are applied independently of the United States - Germany Income Tax Convention. Moreover, permitting continued application of domestic anti-abuse rules is consistent with prevention of fiscal evasion, one of the main purposes of tax conventions.

The case law and the Commentaries provide convincing evidence that the purpose of Article 7, Paragraph 3 of the United States - Germany Income Tax Convention is completely unrelated to the I.R.C. § 882(c)(2) timely filing requirement. Therefore, the I.R.C. § 882(c)(2) timely filing requirement, as set forth in Treas. Reg. § 1.882-4, continues to apply after the effective date of the Tax Convention. *See* S. REP. NO. 445, 100th Cong., 2d Sess. at 317 (1988). Moreover, the "clear repugnancy" that is required for a later legislative enactment to repeal an earlier one by implication is not present in the instant case because the two enactments do not address the same issues and are not irreconcilable. *See Georgia v. Pennsylvania Railroad Co.,* 324 U.S. 439 (1945); *Morton v. Mancari*, 417 U.S. 535 (1974); *Zenith* Radio Corp. v. Matsushita Elec. Indus. Co., 494 F. Supp. 1263,1267 (E.D. Pa. 1980). Because there is no clearly expressed congressional intent that the provisions of the Business Profits Article of the United States - Germany Income Tax Convention repeal the provisions of I.R.C. § 882(c)(2) and its timely filing requirement, and because the two enactments are capable of co-existence, both enactments are required to be regarded as effective concurrently. *Morton v. Mancari*, 417 U.S. at 551.

Finally, had the Taxpayer complied with the minimal requirements of filing a protective return, as permitted by Treas. Reg. § 1.882-4, the Taxpayer would have been permitted deductions and, accordingly, would have been taxed on the business profits determined by the arm's-length standard of Article VII (Business Profits). Treas. Reg. § 1.882-4(a)(3)(iv) provides a foreign corporation with the option to timely file a protective return when it conducts limited activities within the United States which may not give rise to income that is effectively connected with a U.S. trade or business. The foreign corporation may follow this same procedure if it determines initially that it has no U.S. tax liability under the provisions of an applicable treaty. In the event the foreign corporation relies on the provision of an income tax treaty to reduce or eliminate the income subject to taxation, or to reduce the rate of tax, disclosure may be required pursuant to I.R.C. § 6114. By filing a protective return within the time limits set forth under Treas. Reg. § 1.882-4(a)(3)(i), the foreign corporation preserves its rights to allowable deductions and credits, and avoids any potential disallowance of deductions and credits issues that may arise by virtue of I.R.C. § 882(c). On the protective return, the foreign corporation need not report any amounts for gross income, deductions or credits and should simply attach a statement indicating that the return is being filed for protective purposes.

We have not discussed whether the Taxpayer should be allowed the deductions based on general principles of equity. It appears that a more relevant inquiry would be whether the Taxpayer can establish that it is entitled for relief under Treas. Reg. § 1.882-4(a)(3)(ii). That subsection provides:

> The filing deadlines ... may be waived by the District Director or Assistant Commissioner (International), in rare and unusual circumstances if good cause for such waiver, based on the facts and circumstances, is established by the foreign corporation.

There are no legal precedents that define the required threshold for establishing the "rare and unusual circumstances" in which "good cause ... based on the facts and circumstances" may be established under Treas. Reg. § 1.882-4(a)(3)(ii). However, the language "rare and unusual" suggests that the facts and circumstances presented must involve an infrequent or uncommon event that resulted in the Taxpayer's failure to file. Moreover, the regulations should not be broadly interpreted so as to defeat the legislative purpose of disallowing deductions unless a return is filed in a timely manner. If the waiver provision is broadly interpreted, or freely granted, the effect would be to nullify Treasury's sole purpose for issuing deadlines with respect to foreign corporate returns.

We note that because I.R.C. § 882(c)(2), and the related regulations, operate like a penalty provision by disallowing deductions and credits to a foreign corporation when it fails to file a required return, then requesting a waiver of the filing deadlines is analogous to requesting an exemption of the failure to file penalty under I.R.C. § 6651(a)(1). That is, under either of these two situations, the taxpayer is seeking relief from the operation of a penalty provision. However, these two provisions impose different standards of proof before a taxpayer may be relieved from the consequences of the penalty. A foreign corporation requesting a waiver of the filing deadlines must show "good cause" based on the facts and circumstances, whereas a taxpayer seeking relief from I.R.C. § 6651(a)(1) has to establish "reasonable cause." We believe the "good cause" threshold involves a higher standard of proof than what is required under "reasonable cause."

There are insufficient facts presented in the incoming request for us to express an opinion on this facts and circumstances determination. However, a starting point for this inquiry would be, at a minimum, the reasons for the Taxpayer's lack of action, including advice it might have sought and received.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Although not raised by the taxpayer, the facts of this case raise the issue of whether I.R.C. § 884(c)(2), as interpreted by Treas. Reg. § 1.882-4, violates the non-discrimination article of the United States -Germany Income Tax Convention. Paragraph 1 of Article 24 (Non-discrimination) of the United States - Germany Income Tax Convention provides in part::

> Nationals of a Contracting States shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

Paragraph 2 of Article 24 (Non-discrimination) of the United States - Germany Income Tax Convention provides in part:

> The taxation on a permanent establishment that an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

Paragraph 22 of the Protocol provides:

> Paragraph 1 of Article 24 does not obligate the United States to subject an individual who is a German national not resident in the United States to the same taxing regime as that applied to a citizen of the United States not resident in the United States.

The Treasury Department Technical Explanation to paragraph 2 of Article 24 in part provides:

> Paragraph 22 of the protocol relates to this paragraph of the Article. It states that the United States is not obligated, by virtue of paragraph 1 of the Article, to apply the same taxing regime to a German national who is not resident in the United States and a U.S. national who is not resident in the United States. The reason for this is that paragraph of the article applies only when the nationals of the two Contracting States are in the same circumstances. United States citizens who are not residents of the United States but who are, nevertheless, subject to United States tax on their worldwide income are not in the same

> circumstances with respect to United States taxation as citizens of Germany who are not United States residents.

Although Treas. Reg. § 1.882-4 only applies to foreign corporations, and not to domestic corporations, that fact does not give rise to a violation of paragraph 2 of Article 24 of the United States - Germany Income Tax Convention because the difference in treatment is based on the difference in enforcement problems of foreign corporations versus domestic corporations; it is much more difficult for the Service to detect a noncompliant foreign corporation than a noncompliant domestic corporation. Treas. Reg. § 1.882-4 is specifically directed at this difference, which creates a situation "pregnant with the possibilities of tax evasion" and places "a premium on tax evasion." *Blenheim Co., Ltd v. Commissioner,* 125 F.2d 906 (4th Cir. 1942), *aff'g* 42 B.T.A. 1248 (1940); *Taylor Securities, Inc. v. Commissioner,* 40 B.T.A. 696 (1938). I.R.C. § 882(c)(2) was intended to offer strong incentives to foreign corporations to file U.S. income tax returns and, consequently, to reduce the opportunity for tax evasion. *See Espinosa,* 107 T.C. at 152. As set forth in the preamble to Treas. Reg. § 1.882-4, the timely filing requirement is justified because of the different administrative and compliance concerns that are present with respect to foreign corporations that are not present with domestic corporations. I.R.C. § 882(c)(2) and Treas. Reg. § 1.882-4 are specifically directed at the potential of tax evasion, created by the difficulty in identifying foreign corporations, as evidenced from the fact the protective return provisions of Treas. Reg. § 1.882-4 (a)(3)(iv) only requires that the taxpayer identify itself to the Internal Revenue Service; no actual calculation of income, deductions or credits is required.

Treas. Reg. § 1.882-4 is merely a procedural requirement, and differences in procedural requirements are permitted; it is merely taxing non-resident person differently, for practical reasons. Further, Treas. Reg. § 1.882-4 does not result in a different net tax result because as long as the foreign corporation complies with its administrative and procedural requirement, the net tax result for the foreign corporation will be the same as that of a U.S. corporation. Moreover, there is no “clear and manifest” intent on the part of Congress that the non-discrimination Article of the United States - Germany Income tax Convention override I.R.C. § 882(c). *Zenith Radio Corp. v. Matsushita Elec. Indus. Co.*, 494 F. Supp. 1263, 1266 (E.D. Pa. 1980).

The Commentaries to paragraph 4 of Article 24 of the 1977 OECD Model Convention provide that:

> As regards the first sentence [of paragraph 4 of Article 24], experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent

> establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. *The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office....* (Emphasis added.)

We believe these Commentaries highlight the inadvisability of interpreting the nondiscrimination articles in our income tax treaties in a manner that requires absolute consistency in treatment between permanent establishments and resident enterprises. We believe that, in general, domestic laws which impose particular requirements and penalties on foreign corporations do not violate the nondiscrimination articles of our income tax treaties if those laws are specifically designed to address reasonably the unique circumstances of foreign corporations doing business in the United States.

In summary, we believe that section 882(c)(2), as interpreted by Treas. Reg. § 1.882-4, per se, does not violate the Non-discrimination Article of the United States - Germany Income Tax Convention. We believe, however, that the Non-discrimination Article calls for careful consideration of all the facts and circumstances surrounding the application of the provisions of section 882(c)(2) in a particular case. This consideration should include an evaluation of whether or not [redacted]

If you have any further questions, please contact Michael Hara at (202) 622-3134.

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