OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Barbara A. Felker
Chief, CC:INTL:Br3

SUBJECT:

This Field Service Advice responds to your memorandum dated June 9, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

USParent =

State A =
USSub1 =
USSub2 =
UKCFC =
UKHybrid =
Year 1 =
Year 2 =
Year 3 =
X% =
Y% =
Z% =
date A =
£a =

£b	=
£c	=
$d	=
$e	=
$f	=
$g	=
£h	=
£i	=
£j	=
£k	=
£l	=
£m	=
£n	=
£o	=
£p	=
£q	=
$r	=
£s	=
£t	=
£u	=
$v	=
$w	=
£x	=

ISSUE(S): Is USParent entitled to claim a foreign tax credit in Year 1 under section 901 for United Kingdom Advance Corporation Tax ("ACT") paid by UKHybrid in Year 1 and used to offset U.K. corporate tax liabilities of UKHybrid and UKCFC in Years 2 and 3?

CONCLUSION:

It is our opinion that USParent is not entitled to claim a foreign tax credit in Year 1 for all of the refunded portion and most of the unrefunded portion of the ACT. USParent is entitled to claim a foreign tax credit in Year 1 for only that part of the unrefunded portion of the ACT that it used to offset UKHybrid's Year 1 (£a) U.K. corporation income tax. The ACT refund received in Year 3 under Article 10(2)(a)(i) of the U.S.-U.K. Income Tax Treaty is a foreign tax redetermination under section 905(c) that will require USParent to file an amended return for Year 1 to reduce the claimed credit by the refunded portion of the ACT. In addition, the surrender of almost 80% of the ACT by UKHybrid to UKCFC in Year 2 created a deemed refund of ACT to UKHybrid, a capital contribution to UKCFC, and a deemed payment of ACT by UKCFC in Year 2 under the U.S.-U.K. Income Tax

Treaty. See Rev. Proc. 80-18, 1980-1 C.B. 623, and the Technical Explanation to the U.S.-U.K. Income Tax Treaty, 1980-1 C.B. 455. Therefore, a section 905(c) adjustment is required to eliminate the section 901 credit claimed by USParent in Year 1 with respect to the surrendered portion of the Year 1 payment of ACT by UKHybrid. Credit for the surrendered and unrefunded ACT is equally unavailable in Year 1 whether the foreign tax credit is claimed under the U.S.-U.K. Income Tax Treaty or the Code, because the Year 2 surrender of the ACT effected a subsidy within the meaning of section 901(i). Under the Treaty, a foreign tax credit for the unrefunded portion of the surrendered ACT will be available under section 902(b) or 960(a) when UKCFC distributes or is deemed to distribute earnings to UKHybrid. Finally, foreign tax credits for the unrefunded portion of the ACT used by UKHybrid to offset its U.K. corporation tax liability in Year 2 (£b) and Year 3 (£c) would be deferred to those years under the Technical Explanation to the U.S.-U.K. Income Tax Treaty, 1980-1 C.B. 455. A section 905(c) adjustment is required to eliminate the section 901 credit claimed by USParent in Year 1 with respect to the amounts used as an offset in Years 2 and 3. After further factual development, other issues raised by these facts that may affect USParent's entitlement to the credit will be discussed in a future Field Service Advice.

FACTS:

USParent, a publicly traded State A corporation, filed a consolidated Federal income tax return for Year 1 with its subsidiaries, USSub1 and USSub2.

Pursuant to USParent's Board of Directors resolutions, on date A USSub1 and USSub2 formed UKHybrid in the United Kingdom with ownership interests of Y% and Z%, respectively. USSub2 contributed cash in the amount of $d. USSub1 contributed cash in the amount of $e and its stock in UKCFC, which was worth $f. USSub1's basis in the UKCFC stock was $g. Prior to the contribution USSub1 owned X% of the stock of UKCFC, a controlled foreign subsidiary located in the United Kingdom. USSub1's and USSub2's contributions were made within one month of date A.

Under the laws of the United Kingdom, UKHybrid is treated as a corporation. Under the laws of the United States, UKHybrid is treated as a partnership.

In accordance with sections 1491 and 1492, as applicable in Year 1, USParent filed a protective election to apply section 367 principles to the transfer by USSub1 of its stock in UKCFC to UKHybrid in the event it was deemed that the transfer did not directly qualify under section 367. In addition, with respect to that transfer, USSub1 filed Year 1 Form 8838, Consent to Extend the Time to Assess Tax under Section 367-Gain Recognition Agreement, to extend the statute of limitations for 10 years.

UKCFC reported on Schedule J of Form 5471 for Year 1 that it had the following section 964(a) earnings and profits:

	Post-1986 undistributed earnings	Pre-1987 E&P not previously taxed	Previously taxed earnings	Total section 964(a) E&P
Balance at beginning of year	£h	£i	£j	£k
Current year E&P	£l			
Actual distributions of PTI			£m	
Balance at end of year	£n	£i	£o	£p

Within one month of date A, UKCFC distributed its financial instrument to UKHybrid in the face amount of £q. This was the only distribution from UKCFC to UKHybrid in Year 1. UKCFC did not pay any ACT with respect to the distribution of that financial instrument because it and UKHybrid elected under U.K. law to treat the distribution as an unfranked distribution, thereby shifting liability for ACT to UKHybrid. The receipt by UKHybrid of the financial instrument did not increase UKHybrid's U.K. corporate income tax liability because of a group income election. Nonetheless, under U.K. law the distribution increased UKHybrid's retained earnings.

The financial instrument that UKCFC distributed to UKHybrid was labeled "Stock Instrument" and it had a term of 105 years. The instrument was not secured and it was subordinated to all other claims of other creditors. The holders of the instrument did not have the right to vote at any general meeting of UKCFC but they did have the right to designate one director. The instrument required biannual payments which the instrument characterized as interest.

UKCFC made payments to UKHybrid in Year 1 in the amount of $r pursuant to the distributed financial instrument. UKHybrid reported those payments on its Form 1065 for Year 1 as bank interest. UKCFC did not deduct the payments for U.S. E&P purposes.

Within four days of the receipt of the financial instrument and within five weeks of date A, UKHybrid paid cash dividends, under U.K. law, to USSub1 and USSub2 in the amounts of £s and £t, respectively. With regard to those dividends, UKHybrid paid the required ACT at the rate of 25% of the distribution, £u ($v). The total of the cash distributions and ACT paid by UKHybrid equaled the total cash contributions made to UKHybrid by USSub1 and USSub2.

USSub1 and USSub2 treated the payments from UKHybrid as non-taxable partnership distributions as a return of basis. On its Form 1118 for Year 1 USParent reported UKHybrid's ACT payment of $v as a foreign withholding tax under section 901. USParent had excess limitation in the year that preceded Year 1 by two years in the amount of $w, which is slightly less than $v. USParent has indicated it would use that excess limitation to absorb any excess credits carried back from Year 1 after the examination has been completed.

In Year 2, UKHybrid surrendered £x of the ACT it paid in Year 1 to UKCFC to be used to offset UKCFC's U.K. corporation tax liability. The surrendered amount £y was approximately 80% of the total ACT paid by UKHybrid in Year 1. UKHybrid used the remainder of the ACT to offset its Year 1 (£a, or approximately 2% of the total ACT paid in Year 1), Year 2 (£b, or approximately 9% of the total ACT paid in Year 2) and Year 3 (£c, or approximately 9.5% of the total ACT paid in Year 3) U.K. corporation tax liability.

Pursuant to Article 23(a)(i) of the U.S.-U.K. Income Tax Treaty, in Year 3 USSub1 and USSub2 each received a refundable shareholder credit (hereinafter the "ACT refund") in the aggregate amount of one-half of the ACT, net of the required 5% withholding tax imposed by the U.K pursuant to the treaty on those payments, paid by UKHybrid with respect to the Year 1 "dividends."

LAW AND ANALYSIS

The ultimate issue is whether USParent is entitled to claim a foreign tax credit in Year 1 under section 901 for the payment of ACT to the United Kingdom by UKHybrid. Resolution of that issue is dependent upon resolution of several underlying issues, which we discuss below. After further factual development, other issues raised by these facts that may affect USParent's entitlement to the credit will be discussed in a future Field Service Advice.

1. Is USParent correct in its treatment of the financial instrument distributed by UKCFC to UKHybrid within one month of date A as an equity instrument, the distribution of which would be treated as a nontaxable stock distribution under section 305?

In our opinion, based on an analysis of the factors discussed below, the economic reality is that the distributed financial instrument is equity, not debt. As equity of UKCFC, the distributing corporation, the distribution would be treated as a nontaxable stock distribution under section 305.

Whether a financial instrument, analyzed in terms of its economic reality, constitutes equity or risk capital entirely subject to the fortunes of the corporate venture or whether it represents debt is a question of fact to be decided on a case-by-case basis. *Gilbert v. Commissioner*, 262 F.2d 512, 513 (2d Cir. 1959); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d. Cir. 1968); Notice 94-47, 1994-1 C.B. 357. Courts have utilized the following factors in making this determination: (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the instrument; (8) subordination to other claims; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date and the length of time to maturity; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation. *Fin Hay Realty Co.*, 398 F.2d at 696.

Several factors support characterization of the distributed financial instrument as equity:

a. Formal indicia of the instrument. Here, the distributed financial instrument is labeled “Stock Instrument.” However, labels given by parties to a transaction are of little significance where the parties are related, such as in this case. *Fin Hay Realty Co*, 398 F.2d at 697.

b. Maturity date. Here the financial instrument has a term of 105 years. Some courts have held that long-term instruments can be considered as debt. *Monon Railroad v. Commissioner*, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, (instrument with a 50-year term was treated as debt). However, the Service takes the position in Notice 94-47 that a taxpayer’s characterization of an instrument with a term of over 50 years as debt likely will not be respected, depending on the facts and circumstances. The Notice does not set a bright line test with respect to the number of years to maturity for an instrument to be considered equity. In our opinion, an instrument with a 105 year term is equity.

c. Subordination to other claims and risk involved. A financial instrument that is equity is subordinated to the claims of creditors. Secured property is subject to less risk than unsecured property. Here, the distributed financial instrument is not secured and it is subordinated to all other claims of other creditors. The low priority of the unsecured instrument resembles equity. *Fin Hay Realty Co.*, 398 F.2d at 698 and *P.M. Finance Corporation v. Commissioner*, 302 F.2d 786, 789 (3d. Cir. 1962).

d. Voting power and right to designate director. Under its terms the holder of the financial instrument does not have the right to vote at any general meeting of UKCFC. However, the holders of the instrument do have the right to designate a director. Failure to include voting rights is not fatal to characterization as equity.

Some facts, such as the requirement under the instrument that biannual payments be made to UKCFC, the characterization in the instrument of these biannual payments as interest and the reporting of these payments as interest on UKHybrid's Form 1065 for Year 1, would support a conclusion that the instrument is debt. Nonetheless, as stated, in our opinion the preponderance of the factors indicate that the distributed financial instrument is equity. Therefore, its distribution does not result in taxable income to UKHybrid for U.S. tax purposes.

However, for U.K. purposes UKHybrid treated the distribution as shifting retained earnings from UKCFC to UKHybrid. If the distribution had been treated as a stock dividend in the U.K., UKHybrid would not have had enough earnings for the subsequent circular cash flow transaction to have triggered ACT liability. We recommend further factual development to determine whether UKHybrid properly characterized the distribution of the financial instrument as a distribution of UKCFC's earnings for U.K. tax purposes. If UKHybrid did not properly apply U.K. law in this respect, then the cash distribution may not have been a qualifying distribution under U.K. law and UKHybrid's payment of ACT may be a noncompulsory payment of tax and thus ineligible for credit. Treas. Reg. § 1.901-2 (e)(5).

2. Does the ACT refund received by USSub1 and USSub2 require a section 905(c) redetermination?

The Year 3 ACT refund paid pursuant to Article 10(2)(a)(i) of the U.S.-U.K. Income Tax Treaty is a foreign tax redetermination under section 905(c) that will require USParent to file an amended return for Year 1.

Under Article 10(2)(a)(i) of the U.S.-U.K. Income Tax Treaty, U.S. corporate shareholders owning at least 10 percent of the stock of a U.K. corporation are entitled to a refundable tax credit, paid directly from the U.K. government, equal to one-half of the ACT paid by their U.K. subsidiary with respect to dividends received from the U.K. subsidiary. Under Article 10(2)(a)(iii), the sum of the payment from the U.K. government and the dividend paid by the U.K. subsidiary is treated as a dividend for U.S. foreign tax credit purposes, which under Article 10(2)(a)(i) is subject to a U.K. withholding tax of 5 percent. The withholding tax is treated as a creditable income tax paid by the U.S. shareholder under Article 23(1)(b).

Under section 905(c), a taxpayer that claims a foreign tax credit for taxes paid or accrued under section 901 or deemed paid or accrued under sections 902 and 960 must notify the Service of a change in its foreign tax liability that may affect the amount of the foreign tax credit claimed. The change in foreign tax liability may result in a change to the taxpayer's U.S. tax liability for the year in which it originally claimed the taxes as credits, or it may result in an adjustment to the pools of post-1986 foreign income taxes and post-1986 undistributed earnings of a foreign subsidiary in the year in which the foreign tax liability changes. See Treas. Reg. § 1.905-3T.

Here USParent claimed in Year 1 a direct foreign tax credit under section 901 for the ACT paid by UKHybrid, which is classified as a partnership for U.S. tax purposes. A foreign tax redetermination for purposes of section 905(c) occurred in Year 3 when USSub1 and USSub2 received, pursuant to Article 10(2)(a)(i) of the U.S.-U.K. Income Tax Treaty, a refund in the amount of one-half of the ACT, net of the required 5% withholding tax imposed by the treaty on those payments. Article 23(1)(c) of the treaty provides that only the unrefunded half of the ACT is eligible to be treated as an income tax imposed on the corporation paying the dividend. Since it claimed a direct foreign tax credit, under Treas. Reg. §1.905-3T(d)(1) USParent must amend its Year 1 income tax return to take the refund into account.

To the same effect, it appears that the refunded portion of the ACT was not properly creditable in Year 1 since it was substantially certain to be refunded. See Treas. Reg. §1.901-2(e)(2).

3. Does UKHybrid’s offset against its corporation tax liability for Year 2 and Year 3 and surrender of its ACT to its subsidiary UKCFC operate to defer the foreign tax credit for the unrefunded portion of the ACT?

The U.S. tax principles underlying the Technical Explanation to the U.S.-U.K. Income Tax Treaty operate to defer the allowable foreign tax credit for the portion of the ACT used as an offset in Year 2 and Year 3 against UKHybrid’s corporation tax liability until those years. In addition, the Technical Explanation and Rev. Proc. 80-18 also operate to defer the portion of the allowable foreign tax credit attributable to the surrendered portion of the ACT until the credit would be available under section 902 or 960 in connection with a distribution or inclusion from UKCFC.

A U.K. corporation may apply ACT paid in a taxable year to satisfy (offset) its corporation tax liability for that year up to the ACT set off limit. ACT in excess of the amount that can be used to offset corporate tax liability in the year the ACT is paid is referred to as "surplus" ACT. Surplus ACT may be carried over and applied to offset the corporation tax of the distributing corporation for other years. U.K. Income and Corporation Taxes Act (ICTA) 1988, section 239.

Alternatively, a distributing corporation that pays ACT may transfer ("surrender") to one or more 51 percent-owned U.K. subsidiaries the benefit of using the ACT as an offset against its U.K. corporation tax liability. When a U.K. corporation surrenders ACT to a U.K. subsidiary, the corporation that paid the ACT is no longer treated as having paid it and thereafter cannot use the surrendered ACT to offset its corporation tax liability for any year. The corporation to which ACT is surrendered can use the ACT to offset its current, or future, year corporation tax liability. ICTA 1988, section 240.

In Year 2, UKHybrid surrendered £x of the ACT it paid in Year 1 (approximately 80%) to UKCFC to be used by it to offset its U.K. corporation tax liability in that year. UKHybrid used the remainder of the ACT to offset its Year 1 (£a, or approximately 2% of the total ACT paid in Year 1), Year 2 (£b, or approximately 9% of the total ACT paid in Year 1) and Year 3 (£c, or approximately 9.5% of the total ACT paid in Year 1) U.K. corporation tax liability. Pursuant to Article 10(2)(a)(i) of the U.S.-U.K. Income Tax Treaty, USSub1 and USSub2 each received a refund in Year 3 in the amount of one-half of the ACT, net of the required 5% withholding tax imposed by the treaty on those payments, paid by UKHybrid.

Under Article 23(1)(c), the amount of ACT paid by UKHybrid and not refunded under Article 10 is treated as a creditable income tax paid by UKHybrid. Article 23 of the Treaty provides that the allowable amount of the U.S. foreign tax credit for ACT shall be determined “[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)."

The Technical Explanation of the U.S.-U.K. Treaty addresses timing issues that are not specifically addressed in the text of the Treaty. The Technical Explanation allows a U.S. corporate shareholder to compute an amount of deemed paid taxes for unrefunded ACT paid by a U.K. subsidiary in the year the U.K. subsidiary distributes a dividend and pays the ACT, even if the subsidiary does not use the ACT to offset U.K. corporation tax liability in that year. If the ACT never offsets corporation tax liability in another year, it remains permanently a creditable tax of the distributing corporation in the year paid. However, if the ACT is used to offset corporation tax liability in a later year, the Technical Explanation treats the offset as the economic equivalent of a refund of ACT paid in the earlier year and the payment of a creditable corporation tax in the subsequent year. Thus, a section 905(c) redetermination is required to account for that refund. Accordingly, similar to the actual refund received under the treaty by USSub1 and USSub2, use of the offset by UKHybrid in Year 2 and Year 3 will require USParent to file an amended return for Year 1 to reflect the redetermination. An amended return is required since USParent claimed a direct foreign tax credit for the ACT under section 901 in Year 1. *See* Treas. Reg. §1.905-3T(d)(1).

Revenue Procedure 80-18, released on the date the Treaty came into force, elaborates on the Technical Explanation. The Revenue Procedure provides rules for the treatment of ACT paid by a U.K. corporation, surrendered to a U.K. subsidiary and used to offset the subsidiary's U.K. corporation tax liability. The approach adopted is similar to that taken in the Technical Explanation for ACT carried over to a later year of the payor corporation. Under Article 10(2)(a)(iii) of the Treaty and Rev. Proc. 80-18, refunded ACT is not treated as a tax paid, and is treated as a deemed dividend from the U.K. corporation to its U.S. shareholder. The U.S. shareholder may include in its calculation of deemed paid taxes unrefunded ACT in the year paid, even if the U.K. corporation cannot use the ACT to offset its corporation tax liability for the year. If the U.K. corporation surrenders the use of its ACT payment to a U.K. subsidiary in a subsequent year, the parent corporation is treated as having received a refund of ACT paid and made a capital contribution in that amount to its subsidiary, and the subsidiary is treated as having paid ACT in the year in which it is surrendered. Thus, a section 905(c) redetermination is required to account for the deemed refund of the unrefunded portion of the surrendered ACT.

Although both the refunded and unrefunded portions of an ACT payment are treated as surrendered under U.K. law, under Rev. Proc. 80-18 only the unrefunded portion is treated as a capital contribution and accounted for as a tax payment in the subsidiary's post-1986 foreign income taxes pool. The refunded portion is treated as distributed from the parent corporation to the U.S. shareholder. Thus, the subsidiary is considered to have paid or accrued only corporation tax actually paid or accrued in excess of the ACT offset, plus the amount of unrefunded ACT surrendered by the parent. 1980-1 C.B. at 625. The revenue procedure is consistent with U.K. law (ICTA 1988, section 240), which states that the subsidiary, and not the parent corporation, is treated as having paid or accrued the surrendered ACT.

Accordingly, under the revenue procedure, USParent must file an amended return for Year 1 to eliminate the credit for the unrefunded portion of the ACT surrendered to UKCFC in Year 2. An amended return is required since USParent had claimed a direct foreign tax credit for the ACT under section 901 in Year 1. *See* Treas. Reg. §1.905-3T (d)(1).

In *Xerox Corporation v. United States*, 14 Cl.Ct. 455 (1988), the U.S. Claims Court (now called the U.S. Court of Federal Claims) held that the Technical Explanation and Rev. Proc. 80-18 were valid interpretations of the relevant provisions of the U.S.-U.K. Treaty and that Xerox was not entitled to a U.S. foreign tax credit for the portion of the ACT that its first-tier U.K. subsidiary paid in 1974 but surrendered to other U.K. subsidiaries in 1980. The Court of Appeals for the Federal Circuit reversed and held that Xerox was entitled to compute an amount of deemed paid taxes under section 902(a) taking into account the full amount of ACT paid in 1974, and that the later surrender of ACT did not affect the amount of credit allowable in 1974. 41 F.3d 647 (Fed. Cir. 1994). The Federal Circuit concluded that the IRS' position, as stated in the Technical Explanation and Rev. Proc. 80-18, conflicted with the plain language of the Treaty.

The Service published an Action on Decision nonacquiescing in the Federal Circuit's decision. 1997-18 I.R.B. 4. In the Service's view, the decision is contrary to the U.S. foreign tax credit rules, which Article 23(1) of the Treaty expressly incorporates. In addition, the Federal Circuit's decision conflicts with the matching principle underlying section 902 by allowing a distribution of earnings from a U.K. subsidiary to generate a credit for foreign taxes ultimately imposed on earnings of a different entity in a different year. The decision also is contrary to section 902(b), which allows a credit for taxes attributable to earnings of a lower-tier corporation only when that corporation's earnings are distributed up the chain to the U.S. shareholder. The Service is defending the application of the revenue procedure in a surrender situation in a case currently docketed in the Tax Court. *Compaq Computer Corp. v. Commissioner*, Docket No. 24238-96.

4. Should the foreign tax credit be denied to USParent because of the subsidy rule of section 901(i) and Treas. Reg. §1.901-2(e)(3)?

Even if the Federal Circuit was correct in its decision in *Xerox*, in our opinion the surrender of the ACT by UKHybrid created a subsidy to UKCFC within the meaning of section 901(i) and Treas. Reg. §1.901-2(e)(3). Under section 901(i), the surrendered portion of the ACT paid by UKHybrid is not treated as a creditable tax. Section 901(i) was enacted after the years at issue in *Xerox* and applies to USParent whether it claims credit for the ACT under the U.S.-U.K. Income Tax Treaty or under the Code.

Section 901(i) provides as follows:

> (i) Taxes Used to Provide Subsidies.--Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent–
>
> (1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and
>
> (2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

Although the Code section states that the subsidy may be in any form, the regulations at Treas. Reg. §1.901-2(e)(3)(i)(a) state specifically that a subsidy may be in the form of a credit.

In our opinion here there is a subsidy under section 901(i) since the United Kingdom used the ACT that UKHybrid paid in Year 1 to provide a subsidy to UKCFC in the form of a deemed payment of ACT and an offset against the corporation tax owed by UKCFC. The amount of the subsidy was identical to the amount of the surrendered ACT (£x). Therefore, because the surrendered ACT constitutes a subsidy it cannot be treated as a tax paid by UKHybrid for foreign tax credit purposes whether USParent claims the foreign tax credit under the treaty or under the Code.

With regard to claiming the foreign tax credit under the treaty, Article 23(1) provides the general rule that credits will be allowed to U.S. taxpayers for “the appropriate amount of tax paid to the United Kingdom.” However, the credit will be limited by the broad introductory phrase “[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time with out changing the general principle hereof).” Section 901(i), which took effect with regard to taxes paid or accrued in tax years beginning after December 31, 1986, is in our opinion a subsequently enacted limitation to which the treaty parenthetical refers. Thus, there is no conflict between the treaty and the Code. However, even if the subsidy rules were considered to conflict with the provisions of the treaty, the subsidy rules must prevail under the “later-in-time” rule. The principle has long been established that when a treaty and an act of Congress conflict "the last expression of the sovereign will must control". *Chae Chan Ping v. United States*, 130 U.S. 581, 600 (1889); *Whitney v. Robertson*, 124 U.S. 190, 194 (1888); *United States v. Felter*, 546 F. Supp. 1002 (D. Utah 1982), affd. 752 F.2d

1505 (10th Cir. 1985); *Lindsey v. Commissioner*, 98 T.C. 672, 676 (1992). In 1988, Congress codified this rule in section 7852(d)(1).

Similarly, the subsidy rule of section 901(i) will operate to deny the claimed foreign tax credit to USParent in Year 1 should it assert its right to the credit under the Code. Firstly, its right to a credit under the Code is problematic, regardless of whether the subsidy limitation applies. Creditability of ACT under the Code has never been addressed by the Service or the courts. In fact, the Senate Committee on Foreign Relations at the time the Senate was considering the ratification of the Treaty expressed doubts over whether ACT would meet the Code's requirements to qualify as a creditable tax. S. Exec. Rep. No. 18, 95th Cong., 2d sess. (1978), 1980-1 C.B. 411, 427. Secondly, even assuming that ACT otherwise qualifies as a creditable tax, the U.S. tax principles underlying the Technical Explanation and Rev. Proc. 80-18 apply with equal force whether credit is claimed under the Treaty or the Code. Finally, USParent would not be entitled to a foreign tax credit in Year 1 for the surrendered portion of the ACT because, as discussed above, the surrendered ACT was used by the U.K. to provide a subsidy to UKCFC within the meaning of section 901(i).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

There are litigation hazards with regard to the issue involving deferral of the foreign tax credit for the ACT because of the Federal Circuit's decision in *Xerox*. Likewise, there are litigation hazards with regard to the untested subsidy theory, which is currently under consideration by the Tax Court.

If you have any further questions, please call (202) 622-3850.

BARBARA A. FELKER
Chief, CC:INTL:Br3