**INTERNAL REVENUE SERVICE**
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference: March 14, 2001

LEGEND:

Corp A:

Year 1:

Year 2:

ISSUE:

Whether, for purposes of computing the taxpayer's foreign tax credit limitation, Article XXIV(3) of the Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital, signed Sept. 26, 1980, entered into force Aug. 16, 1984, as amended by Protocols entered into force Aug. 16, 1984, Nov. 9, 1995 and Dec. 16, 1997, 1 Tax Treaties (CCH) at ¶ 1901 (the "Treaty") prohibits the United States from applying U.S. law to allocate a portion of the taxpayer's aggregate interest expense to its gross income attributable to permanent establishments maintained in Canada and to dividends received from a Canadian corporation when the interest expense is not deductible for Canadian tax purposes.

CONCLUSION:

Although Article XXIV(3) requires the United States to treat the taxpayer's income attributable to the permanent establishments maintained in Canada and the dividends received from the Canadian corporation as Canadian source income for purposes of computing the taxpayer's allowable foreign tax credit, Article XXIV(3) does not prohibit the United States from applying U.S. law to compute the amounts of these items. Therefore, for purposes of computing the taxpayer's foreign tax credit limitation, the United States may apply its interest expense apportionment rules to allocate a portion of the taxpayer's aggregate interest expense to the gross amount of these items, regardless of the fact that the interest expense is not deductible for Canadian tax purposes.

FACTS:

Corp A is a domestic corporation, which, together with its domestic subsidiaries, files a consolidated federal income tax return. During Year 1 and Year 2, two domestic subsidiaries of Corp A derived income attributable to permanent establishments in Canada. A third domestic subsidiary of Corp A received dividends from a Canadian corporation wholly owned by the subsidiary. Corp A and the domestic subsidiaries included in the Corp A consolidated group are collectively referred to as "the taxpayer."

In computing its foreign tax credit limitation under section 904 for Year 1 and Year 2, the taxpayer allocated its worldwide interest expense solely to reduce U.S. source income. The Service proposed to allocate a portion of the taxpayer's deductible interest expense to the business profits attributable to the Canadian permanent establishments and to the dividends received from the Canadian corporation. Canada did not allow a deduction for the interest expense in computing the amount of income subject to Canadian tax.

LAW AND ANALYSIS:

1. U.S. Law

Section 901(a) permits a taxpayer to elect to credit income taxes paid or accrued to a foreign country against the taxpayer's U.S. federal income tax.

Section 904(a) limits the amount of foreign income taxes that a taxpayer may credit during any one year to the taxpayer's pre-credit U.S. tax on its foreign source taxable income (the "foreign tax credit limitation"). The foreign tax credit limitation is computed by multiplying the taxpayer's pre-credit U.S. income tax liability by the ratio of the taxpayer's foreign source taxable income to its worldwide taxable income. A taxpayer's foreign source taxable income (the numerator of the ratio) is determined by deducting from a taxpayer's foreign source gross income the expenses, losses and deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. Sections 862(b) and 863(b). Consequently, expenses, losses and other deductions that are properly allocated or apportioned to a taxpayer's foreign source gross income reduce the taxpayer's foreign source taxable income, which correspondingly reduces the taxpayer's foreign tax credit limitation.

Section 864(e) and Treas. Reg. § 1.861-9T contain rules for allocating and apportioning a taxpayer's deductible interest expense. The method of allocation and apportionment provided for in the regulation is based on the approach that money, in general, is fungible. Treas. Reg. § 1.861-9T(a). Consistent with this principle, interest expense is considered related to all income-producing activities and assets of the taxpayer. Id. Accordingly, a taxpayer's aggregate interest expense is generally ratably apportioned to a taxpayer's foreign source gross income based on the portion of the taxpayer's assets that generate foreign source income. Section 864(e)(2); Treas. Reg. § 1.861-9T(g).

For taxpayers that are members of a consolidated group, the foreign tax credit limitation and the interest expense apportionment rules are applied on a group wide basis. See section 864(e)(1); Treas. Reg. §§ 1.861-9T(a), 1.861-11T and 1.1502-4.

2. The Treaty

Article III(2) addresses terms that are not defined in the Treaty. It provides:

> As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires and subject to the provisions of Article XXVI (Mutual Agreement Procedure), have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Article VII governs business profits earned by a resident of a Contracting State. It provides that business profits earned by a resident of one Contracting State may be taxed by the other Contracting State to the extent the business profits are attributable to a permanent establishment of the resident in such other Contracting State. Article VII(1). Although Article VII contains certain rules for determining business profits attributable to a permanent establishment, the term "business profits" is left undefined. Accordingly, a Contracting State applies its own rules to determine the business profits attributable to a taxpayer's permanent establishment located in the Contracting State. Article III(2); Staff of the Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty (and Proposed Protocols) between the United States and Canada, 1 Tax Treaties (CCH) at ¶ 1952 ("Joint Committee Explanation"); Senate Foreign Relations Committee, Report on the Income Tax Treaty Signed with Canada on Sept. 26, 1980, and on the Protocols Signed on June 14, 1983, and March 28, 1984, 1 Tax Treaties (CCH) at ¶ 1955 ("Senate Report").

Article X governs dividends received by a resident of one Contracting State from a company that is a resident of the other Contracting State. It provides that such dividends may be taxed by the Contracting State in which the recipient of the dividend resides. Article X(2). The Contracting State in which the company resides is also permitted to tax the dividends, but generally not in excess of 5 percent of the gross amount of such dividends (in the case of 10 percent or more shareholders) or 15 percent of the gross amount of the dividends (in the case of less than 10 percent shareholders).

Article XXIV imposes certain obligations on the Contracting States to mitigate double taxation. In the case of the United States, Article XXIV(1) provides as follows:

> . . . In 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 United States shall allow to a citizen or resident of the United States . . . as a credit against the United States tax on income the appropriate amount of income tax paid or accrued to Canada; . . .

The Treasury Department Technical Explanation of the Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital Signed at Washington, D.C. on Sept. 26, 1980, as Amended by the Protocol Signed at Ottawa on June 14, 1983 and the Protocol Signed at Washington on March 28, 1984, 1 Tax Treaties (CCH) ¶ 1950 (the "Technical Explanation") expressly identifies section 904 as one of the applicable limitations of U.S. law that applies in determining a taxpayer's allowable credit.

Article XXIV(3) contains sourcing rules that apply for purposes of Article XXIV. Subparagraph (a) of Article XXIV(3) provides as follows:

> Profits, income or gains . . . of a resident of a Contracting State which may be taxed in the other Contracting State in accordance with the Convention . . . shall be deemed to arise in that other State; . . .

3. Interaction Between U.S. Law and the Treaty

The U.S. foreign tax credit and interest expense apportionment rules require the taxpayer, in computing its foreign tax credit limitation, to allocate a portion of its interest expense to its gross income attributable to the Canadian permanent establishments and the dividends received from the Canadian corporation. The issue is whether Article XXIV(3) prohibits the United States from apportioning interest expense to these items of gross income when the interest expense is not deductible from such items for Canadian tax purposes. The taxpayer argues that it does, and Exam argues that it does not. We note that although the issue in the present case is limited to the apportionment of the taxpayer's interest expense, the issue may also be presented more generally as whether Article XXIV(3) precludes the United States from applying its own rules for computing the amount of a taxpayer's taxable income attributable to Canadian permanent establishments and to dividends from Canadian corporations when the U.S.

rules result in a different amount of Canadian source taxable income than the amount determined under Canadian law.

A. Taxpayer's Position

The taxpayer's view is that Canadian law determines both the amount of business profits and dividend income Canada is permitted to tax under Articles VII and X, respectively, and the amount of income the United States must treat as Canadian source under Article XXIV(3). Since Canada does not allow the taxpayer to deduct any of the interest expense in determining the taxable amount of its business profits or dividends, the taxpayer argues the United States is precluded from applying its interest expense apportionment rules to reduce the amounts of these items for foreign tax credit limitation purposes. The taxpayer cites Rev. Ruls. 78-423, 1978-2 C.B. 194, 85-7, 1985-1 C.B. 188, 89-115, 1989-2 C.B. 130, 79-28, 1979-1 C.B. 457 and 79-206, 1979-2 C.B. 279, National Westminster Bank, PLC v. United States, 44 Fed. Cl. 120 (1999), appeal denied, 232 F.3d 902 (Fed. Cir. 2000), and North West Life Assurance Co. of Canada v. Commissioner, 107 T.C. 363 (1996) in support of its position. The taxpayer also cites Article XXIV(1) and Article III(2), arguing that Article III(2) requires the United States to determine the "appropriate amount" of the taxpayer's foreign tax credit under Article XXIV(1) by reference to its taxable income as computed under Canadian law because it is Canada's right to tax that is at issue. In addition, the taxpayer argues that because Articles VII and X allocate taxing jurisdiction to Canada with respect to taxpayer's business profits and dividends, Canadian law must determine the amount of such items treated as Canadian source income in order to avoid double taxation as contemplated by the Treaty. The taxpayer argues that this is especially true in the case of interest expense, which is a significant item in determining the taxpayer's taxable income from Canada. Finally, citing United States v. Stuart, 489 U.S. 353, 368 (1989), and Estate of Burghardt v. Commissioner, 80 T.C. 705 (1983), aff'd without published opinion, 734 F.2d 3 (3d Cir. 1984), the taxpayer argues that treaties should be liberally construed in favor of granting rights, rather than restricting them.

B. Discussion

In construing treaty provisions, courts examine the purpose the provision within the context of our domestic law. Great-West Life Assurance Co. v. United States, 678 F.2d 180, 183 (Ct. Cl. 1982). Courts endeavor to construe a treaty and domestic law so as to give effect to both. Whitney v. Robertson, 124 U.S. 190, 194 (1888). Therefore, Article XXIV(3) should be construed so as to give effect to that provision in a manner that is consistent with the foreign tax credit provisions of the Code.

Article XXIV(1) requires the United States to allow a credit "[i]n accordance with the provisions and subject to the limitations of the law of the United States" for "the appropriate amount" of income tax paid or accrued to Canada. Thus, under the express language of Article XXIV(1), the United States applies its domestic rules, including the limitations contained therein, to determine the appropriate amount of Canadian income taxes that may be credited against U.S. tax. One of the limitations of U.S. law that applies in determining a taxpayer's allowable foreign tax credit is the foreign tax credit limitation. Technical Explanation. Accordingly, under Article XXIV(1), the United States is entitled to apply the foreign tax credit limitation and other relevant provisions of U.S. law to determine a taxpayer's allowable foreign tax credit.[1]

The foreign tax credit limitation limits the taxpayer's allowable credit to its pre-credit U.S. income tax liability multiplied by the ratio of its foreign source taxable income to its worldwide taxable income. Section 904(a). To calculate foreign source taxable income, the U.S. interest expense apportionment rules require the taxpayer to allocate a portion of its interest expense to its gross income attributable to the permanent establishments in Canada and to the gross dividends received from the Canadian corporation. Therefore, under Article XXIV(1), the United States is permitted to reduce these gross amounts by the interest expense allocated thereto in computing the taxpayer's foreign source taxable income for purposes of determining the taxpayer's allowable foreign tax credit.

Article XXIV(3) does not change this result. Article XXIV(3) applies to determine the source of the "profits, income or gains" of a resident of one Contracting State that the other Contracting State is permitted to tax. It requires the residence State to treat such amounts as arising in the other State. However, Article XXIV(3) does not define the term profits, income or gains. Undefined terms are given the meaning they have under the tax laws of the State applying the Treaty. Article III(2); Joint Committee Explanation; Senate Report. This means that in the case of the United States applying Article XXIV(1) and (3) to determine a taxpayer's allowable foreign tax credit, the terms profits, income and gains are given the meanings they have under U.S. law. Accordingly, the "profits, income or gains" of the taxpayer attributable to its Canadian permanent establishments and the dividends received from the Canadian corporation are computed under U.S. law for foreign tax credit purposes. Although Article XXIV(3) requires the United States to treat the taxpayer's business profits and dividends as Canadian source income, Article XXIV(3) does not preclude the United States from reducing the gross amount of these items by the interest expense apportioned thereto pursuant to U.S. law.

This view of Article XXIV(3) is consistent with the purpose of Article XXIV. The purpose

[1]We note that, contrary to the taxpayer's position, it is the United States's right to tax that is at issue under Article XXIV(1) since Article XXIV(1) concerns the United States's obligation to allow a U.S. resident a credit against its U.S. income tax liability. Accordingly, under Article III(2), U.S. law would apply to determine the "appropriate amount" of Canadian income tax allowable as a credit even in the absence of the express language contained in Article XXIV(1).

of Article XXIV is to relieve a taxpayer from double taxation in cases where the Treaty permits both the United States and Canada to tax an item. Joint Committee Explanation; Senate Report. This purpose is achieved when credit is allowed for foreign taxes to the extent of a taxpayer's U.S. income tax liability attributable to income derived in Canada. In the instant case, taxpayer's U.S. income tax due with respect to its income from the permanent establishments in Canada and the dividends from the Canadian subsidiary is based on the gross amounts of these items less the interest and other expenses allocated and apportioned thereto. Consequently, in contrast to the taxpayer's assertions, double taxation is relieved with respect to its taxable income from the permanent establishments and the dividends since the taxpayer's allowable foreign tax credit, as computed under U.S. rules, eliminates the U.S. tax due with respect to such items.

As mentioned, the taxpayer cites several authorities in support of its position. The taxpayer's reliance on these authorities is misplaced. Rev. Ruls. 78-423, 85-7 and 89-115 held that, under the treaties at issue, the United States was entitled to apply its own interest expense apportionment rules to determine the amount of business profits attributable to permanent establishments maintained in the United States. National Westminister Bank and North West Life held that the United States was precluded from applying certain domestic rules in determining the amount of business profits attributable to permanent establishments maintained in the United States because the domestic rules were found to conflict with the business profits articles of the treaties at issue. Taken together and applied to the instant case, these authorities stand for the proposition that Canadian law determines the taxpayer's business profits that Canada is entitled to tax under Article VII of the Treaty, subject to certain limitations that may be imposed on such determination by Article VII. Thus, these authorities relate only to Canada's right to tax the taxpayer under Article VII, not to the United States's obligation to give a foreign tax credit under Article XXIV(1) and (3).[2] Rev. Ruls. 79-28 and 79-206 held that a sourcing rule in the U.S. - Japan Income Tax Convention required the United States to treat as foreign source income compensation income that was U.S. source income under the Code. Although these rulings support the position that the United States must treat the taxpayer's business profits and dividends as Canadian source income, they do not support the position that Canadian law determines the amounts of such items for foreign tax credit purposes.

Taxpayer's reliance on the argument that treaties should always be liberally construed to provide benefits is also misplaced. In Stuart and Estate of Burghardt, the courts

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[2]We express no opinion on the extent to which Article VII, including paragraphs (2) and (3) thereof, may limit Canada's right to apply its domestic law in computing the amount of business profits taxable in Canada. See also Article XXVI (authorizing the competent authorities to agree to the same attribution of profits to a taxpayer's permanent establishment).

construed the relevant treaty provisions to reach results that harmonized the treaty with domestic law as much as possible. Taxpayer's interpretation of the treaty violates the tenets of domestic law much more than is necessary to carry out the intent of Article XXIV(3). Moreover, those cases involved the interpretation of treaties for the benefit of foreign persons and not U.S. citizens. U.S. tax treaties are not negotiated to provide benefits to U.S. persons except in very narrow and expressly prescribed circumstances. See Article XXI(5) (Exempt Organizations) (which permits U.S. residents to take a deduction for U.S. purposes for contributions to Canadian charities); Senate Report (stating that treaties are not a proper forum for granting U.S. persons deductions not otherwise allowed under the Code); Johnson v. Browne, 205 U.S. 309, 321 (1907) (implicit overrides of U.S. law by treaties are not favored). Thus, a treaty should not be construed to provide U.S. residents with U.S. tax benefits other than those expressly provided for in the treaty. In the instant case, Article XXIV(3) does not expressly provide that the U.S. expense allocation and apportionment rules shall not apply for purposes of determining the amount of a taxpayer's foreign tax credit limitation. Accordingly, Article XXIV(3) can and should be construed to permit the United States to apply its interest expense apportionment rules in determining the taxpayer's foreign tax credit limitation.

Finally, we note that the taxpayer's position is inconsistent with the basic purpose of the foreign tax credit limitation, which is incorporated in Article XXIV(1). Article XXIV(1); Technical Explanation. The Joint Committee Explanation describes the purpose of the foreign tax credit limitation as follows:

> A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that insures that the foreign tax credit offsets only U.S. tax on foreign source income.

Accord Senate Report. Thus, the foreign tax credit limitation is intended to prevent foreign tax credits from offsetting U.S. tax due with respect to U.S. source income. The taxpayer's interpretation of Article XXIV(3) would circumvent this purpose because it would have the effect of converting into foreign source income a portion of the taxpayer's U.S. source income that has no relation to its Canadian activities, thereby allowing a credit against the U.S. tax imposed with respect to U.S. source income.

CAVEAT:

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